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DEFICIENT TREATMENT OF DEFICIENCY CLAIMS: GILMORE WOULD HAVE REPENTED

DONALD J. RAPSON*

Professor Grant Gilmore was one of the Co-Reporters for the original Article 9—and its primary drafter.¹ His brilliant treatise, *Security Interests in Personal Property*,² stands as the leading exposition of the history of secured transactions law and its emergence as Article 9—Secured Transactions of the Uniform Commercial Code (“UCC”). To me, he has always been one of the revered “gods” of the UCC.

I was introduced to Gilmore in 1954 by Professor John Hanna of Columbia Law School, for whom I was a research assistant. Hanna was the Consultant on Article 9 for the monumental study of the UCC by the New York Law Revision Commission.³ I vividly remember attending one of the Commission hearings with Hanna where Gilmore exploded with anger and fury at a bankers’ association memorandum criticizing draft Article 9, which he castigated for lack of intellectual honesty and for being crammed with misstatements.⁴ Regrettably, there are not many commercial law teachers around today with his passion and dedication to principle. Although I never knew him well, we corresponded in later years and his pungent comments in a letter about Article 4 offer a good insight to Gilmore’s candor.⁵

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1. BARKLEY CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 1.01[2][c], at 1-8 (rev. ed. 1993).

2. GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* (1965).

3. NEW YORK LAW REVISION COMM’N, N.Y. LEG. DOC. NO. 65(A), *REPORT OF THE LAW REVISION COMMISSION TO THE LEGISLATURE RELATING TO THE UNIFORM COMMERCIAL CODE* (1956).

4. My recollection is that this took place at a hearing in 1954 in New York City at the Association of the Bar of the City of New York. It was undoubtedly recorded in the transcripts of the Law Revision Commission.

5. Donald J. Rapson, Book Review, 41 *BUS. LAW.* 675, 676 (1986) (reviewing FRED H. MILLER & ALVIN C. HARRELL, *THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES* (1985)).

Professor Gilmore was principally responsible for the exalted status of the Article 9 “good faith purchaser”⁶—a doctrine I have questioned insofar as it provides protections to nonreliance parties.⁷ In an overlooked late article,⁸ Gilmore expressed his concern and regrets about “some of the article 9 excesses” and described how he did penance as chairman of a special committee of the National Bankruptcy Conference in connection with the 1978 Bankruptcy Code.⁹

I have represented secured creditors for most of my professional life, twenty-six years of which were in private practice and the last thirteen years were with The CIT Group, Inc. (“CIT”).¹⁰ During that time, I have handled in some capacity many real estate mortgage and personal property security interest foreclosures, and the deficiency actions resulting therefrom. Much of my thinking has been guided by the reputable practices of business people at CIT and other lenders I represented in private practice and the rules and

6. Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954).

7. Donald J. Rapson, *A “Home Run” Application of Established Principles of Statutory Construction: U.C.C. Analogies*, 5 CARDOZO L. REV. 441, 445-47 (1984).

8. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605 (1981); see also ROBERT A. HILLMAN ET AL., COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE ¶ 1.02, at 1-3 (1985).

Criticism of the Code has been particularly noteworthy because it has been led by the late Professor Gilmore, the principal draftsman of Article 9 of the Code. Gilmore . . . made no effort to spare his own child; indeed, he may as part parent have seen the Code’s vices in magnified form.

Id.

9. Gilmore, *supra* note 8, at 627-28. Professor Homer Kripke, another architect of Article 9, and the principal drafter of the 1972 Revisions to Article 9, upon learning of Gilmore’s changed views wrote:

Professor Grant Gilmore, for whom my admiration is unlimited, has recently astounded his old comrades among the Code draftsmen by repudiating many of the conclusions of his splendid article, *The Commercial Doctrine of Good Faith Purchase* [Gilmore, *supra* note 6]. . . . I do not go along, in general, with his changed viewpoint. . . . I do not understand what led Gilmore to his current view.

Homer Kripke, *A Reflective Pause Between UCC Past and UCC Future*, 43 OHIO ST. L.J. 603, 608 n.23 (1982).

10. While a student at Columbia Law School from 1951 to 1954, I did volunteer work for the New York Legal Society in Harlem. One of the major problems I worked on was the defense of poor consumers against banks suing to collect unpaid balances for goods sold under retail installment contracts, where the goods were defective but the banks claimed that they were holders in due course, free of that defense or recoupment claim. That experience had a profound impact on me in later years when I represented secured creditors and motivated me to urge fair and equitable practices—which in my view, are also “good business.” The potential for consumer abuses arising from the holder in due course doctrine was anticipated by UCC section 9-206(1), and the doctrine was, of course, eventually abrogated in consumer transactions by the Federal Trade Commission. See *Preservation of Consumers’ Claims and Defenses*, 16 C.F.R. pt. 433 (1996).

procedures of the New Jersey and New York courts.

For the last five years, as a member of the Article 9 Drafting Committee, I have vigorously urged the adoption of a “fair value” rule to curb a sometimes abusive practice that occurs in the enforcement of deficiency claims—particularly in the circumstance where the secured party, or one with whom it has a relationship, has “bought in” the collateral at the foreclosure sale.¹¹ At the outset there was surprising and sustained resistance to this proposal by the Drafting Committee.¹² There was, however, gradual progress in recent years, described below, and most recently a gratifying decision by the Drafting Committee, which leads me to believe that a revised Article 9 will afford significant relief.¹³

The fair value rule is not new and, in the past, has not been particularly controversial. In essence, it allows the debtor to challenge the calculation of a deficiency claim based on the foreclosure sale price because the fair value of the collateral exceeded that price. Indeed, it is the majority rule in real estate law,¹⁴ was the statutory rule in personal property secured transactions law in some states prior to the adoption of Article 9,¹⁵ and, in some states, continues to be applied by decisional law in cases where the debtor contests the amount of a deficiency claim.¹⁶ In many states, however, and in the minds of some

11. See Donald J. Rapson, *Repurchase (of Collateral?) Agreements and the Larger Issue of Deficiency Actions: What Does Section 9-504(5) Mean?*, 29 IDAHO L. REV. 649, 680-92 (1992-1993). “Bought-in” is an euphemism that describes the result of the secured party being the successful purchaser at a foreclosure sale. See *infra* note 22 explaining the secured party’s “credit bid.”

12. The Article 9 Drafting Committee is chaired by William M. Burke, Esq., of Los Angeles, California. The Reporters are Professor Steven L. Harris of the Illinois Institute of Technology, Chicago-Kent College of Law and Professor Charles W. Mooney, Jr., of the University of Pennsylvania Law School. The other members of the Drafting Committee were initially William S. Arnold, Esq. of Crosssett, Arizona, Prof. Marion W. Benfield, Jr., of Wake Forest University Law School, Winston-Salem, North Carolina, Trudi Bird, Esq. of Stonington, Connecticut, Dale G. Higer, Esq. of Boise, Idaho. The Honorable William C. Hillman of the U.S. Bankruptcy Court, Boston, Massachusetts, Prof. Randal Picker of the University of Chicago Law School, Donald J. Rapson, Esq. of Livingston, New Jersey, Harry C. Sigman, Esq. of Los Angeles, California, Bradley Y. Smith, Esq. of New York, New York, Edwin E. Smith, Esq. of Boston, Massachusetts, and Sandra S. Stern, Esq. of New York, New York. Mr. Arnold died and Ms. Bird resigned. Michael Houghton, Esq. of Wilmington, Delaware is a new member of the Committee.

13. See *infra* notes 82-116 and accompanying text.

14. RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.4 (Tentative Draft No. 5, Mar. 18, 1996) [hereinafter RESTATEMENT OF MORTGAGES].

15. *E.g.*, N.J. STAT. ANN. § 46:32-28 (repealed 1961); N.Y. PERS. PROP. LAW §§ 80-b, 81 (repealed 1964) (for conditional sales contracts with prices of \$1500 or less); see also N.Y. LIEN LAW §§ 239, 239-a to -l (repealed 1964) (relating to chattel paper).

16. *E.g.*, Citibank v. Errico, 597 A.2d 1091, 1097 (N.J. Super. Ct. App. Div. 1991) (even though a deficiency action based on a foreclosure of a note and real estate mortgage securing a debt for

secured transactions experts, it is not the rule under Article 9—and should not be the rule.¹⁷ How did this happen?

Much of the opposition came from people I highly respect who have an abiding and sincere concern that adoption of a fair value rule is not only unnecessary, but will result in judicial and economic inefficiency caused by burdensome transaction costs. For me, such efficiency concerns should, as a general rule, give way to individual justice and equity. A debtor should have the right to challenge a deficiency claim by establishing that the fair value of the collateral securing the obligation has not been credited against that obligation. Moreover, I do not agree that such a right will produce the asserted burdens and inefficiencies. Rather, I believe that the rule is consonant with the existing practices and procedures of reputable and efficient secured creditors and that its adoption will contribute to a general elevation of the standards and operational procedures of secured financing. That, of course, will inure to the benefit of debtors and other creditors and should ameliorate a present source of friction and controversy. In short, no inherent inconsistency exists between rules that facilitate and promote the ability of financiers to provide secured credit and a rule that allows debtors to challenge deficiency claims against them that are calculated on the basis of a foreclosure sale price

business or commercial purposes is not subject to the real property fair market value deduction statute, in order “to preclude a windfall under general equitable principles,” the debtor was entitled to “a deficiency hearing at which the fair market value of the property at the time of foreclosure sale shall be determined and the calculation of any credit to be allowed defendant in the deficiency action”); *see also* Vito’s Towing, Inc. v. Kemp, 652 A.2d 1259 (N.J. Super. Ct. App. Div. 1995) (fair value applied to public sale of an abandoned car); FDIC v. Forte, 463 N.Y.S.2d 844, 850 (App. Div. 1983) (even though the deficiency action based on a foreclosure sale of a real estate note and mortgage was governed by UCC section 9-504 and not by the real property fair market value deduction statute, the debtor was entitled to a hearing on the alleged “marked discrepancy between the foreclosure sale price and the value of the property” because “a marked discrepancy between the sale price and the value of the property will trigger close scrutiny even in the face of procedural propriety.”). The challenge to the foreclosure sale price of \$165,000 in *Forte* was based upon appraisals of the real property that differed by approximately \$200,000. *Id.* at 850. Although the court termed the issue as one of commercial reasonableness, the practical effect of the decision was to allow the debtor to use fair value concepts to mount its challenge. New York courts that follow the rebuttable presumption rule allow the secured party to recover a deficiency even though the foreclosure sale was commercially unreasonable, *see infra* notes 66-67, and similarly use the difference between the “fair and reasonable value” of the collateral and the amount of the debt as the measure of the deficiency. *See* Siemens Credit Corp. v. Marvik Colour, Inc., 859 F. Supp. 686, 693 (S.D.N.Y. 1994); General Elec. Credit Corp. v. Durante Bros. & Sons, 433 N.Y.S.2d 574, 576 (App. Div. 1980).

17. Steven O. Weise, *U.C.C. Article 9—Personal Property Secured Transactions*, 47 BUS. LAW. 1593, 1639 (1992) (“U.C.C. Section 9-504(3) requires only that the *procedures* involved be commercially reasonable and not that they generate a commercially reasonable price.”); CLARK, *supra* note 1, ¶ 4.08[8][b], at 4-165.

that does not reasonably approximate the fair value of the collateral. I have written this Article to advocate and urge that position.

In looking for guidance, I, of course, turned to Gilmore's treatise. Sure enough, he discussed the issue which he described as a "really hard"¹⁸ and a "really serious problem":

The really serious problem is whether a secured party who has complied with the notification and publicity requirements as well as the formalities is privileged, if the lively concourse of bidders fails to materialize, to buy the property in at a price which (let us assume, *arguendo*) is a fraction of its real value. . . .

....

. . . [I]s there any obligation on a secured party, who has scheduled a public sale, sent out the required notifications and provided appropriate publicity, to bid more than a minimum price?¹⁹

His conclusion as to how the issue should be resolved under Article 9 is troubling and makes me shout, "Say it ain't so, Grant."²⁰ Gilmore appears to have concluded that if the sale satisfies the procedural requirements of "commercial reasonableness," the transaction is "unassailable."²¹ If, by unassailable, he only meant that the sale and resulting transfer should not be voided or otherwise disturbed because it was regularly conducted in compliance with applicable procedural requirements, I would not be concerned. But, if he also meant that the secured party can recover a deficiency based upon its own "credit bid," even though the amount of that bid is far less than the value of the collateral, that conclusion was wrong and has led to unfortunate results. Article 9 should be revised to state a different

18. See 2 GILMORE, *supra* note 2, § 44.6, at 1245.

19. *Id.* § 44.6, at 1243-44. In my view, this discussion by Gilmore is indicative of the fact that Article 9 offers very little guidance concerning the calculation of deficiency claims. As Gilmore also acknowledged, "All that Article 9 has to say about liability for a deficiency is the simple statement in § 9-504(2). . . ." *Id.* § 44.9.4, at 1261.

20. Baseball lore has it that a young Chicago White Sox fan upon learning that his hero, "Shoeless" Joe Jackson, the great hitter, was a key figure in the 1919 "Black Sox" scandal to throw the World Series, pleaded, "Say it ain't so, Joe!" Baseball history says that the boy actually said, "It ain't true, Joe!" See *Baseball* pt. 3 (Pub. Broad. Television 1994).

21. 2 GILMORE, *supra* note 2, § 44.6, at 1245; see *infra* note 23 and accompanying text; cf. UNIF. FRAUDULENT TRANSFER ACT § 3(b) (1984), 7A U.L.A. 639, 650 (1985) (protecting foreclosure sales from being avoided for not satisfying the requirement of reasonably equivalent value, if there is a "regularly conducted, non-collusive foreclosure sale"). The *Fraudulent Transfer Act* provision has nothing to do with deficiency claims and in no way mandates that the foreclosure sale price be used in calculating a deficiency claim. See *infra* notes 28-30, 53-54, 63 and accompanying text.

rule that would negate such an interpretation and allow Professor Gilmore a posthumous repentance.

Part I of this Article examines the fair value rule in the context of Gilmore's perception of the commercial reasonableness concept. Part II discusses the reaction to, and progress of, the fair value proposal in the Article 9 Drafting Committee.

I. COMMERCIAL REASONABLENESS AND THE CALCULATION OF DEFICIENCY CLAIMS

A. *The Issue*

Let us put the issue in perspective with a hypothetical, but typical, set of facts and two possible case scenarios. In developing this hypothetical, the collateral involved is not described and relatively large dollar amounts are used for the express purpose of *not* drawing a distinction between commercial and consumer transactions. In my view, even though consumer representatives have spoken out most forcefully about the problem, it is not limited to consumer transactions.

Bank financed Debtor's purchase of Property for \$100,000. The Property is the collateral for Debtor's debt to Bank. After making payments reducing the debt to \$80,000, Debtor defaulted and Bank proceeded to foreclose by public sale of the collateral pursuant to applicable state law, viz. state mortgage foreclosure law if the collateral was real property or UCC Article 9 if the collateral was personal property. Bank gave proper notice to Debtor and any other required person and also properly advertised the public sale in compliance with the procedural requirements of applicable law (i.e., the procedure satisfied the requirements for commercial reasonableness under UCC § 9-504). Prior to holding the sale, Bank evaluated the collateral and determined that it had a value ranging from a minimum of \$50,000 to a maximum of \$60,000. As a consequence, Bank established a "let go" or "upset" price of \$50,000 which it was prepared to bid up to before it would let a third party purchase the collateral.

Case #1

At the sale, Third Party purchased the collateral for \$55,000. Thirty days later Third Party sold the collateral to Fourth Party for \$70,000. Bank instituted a deficiency action against Debtor for \$25,000.

Case #2

At the sale, no other bidders appeared. Bank bought-in the collateral with a credit bid²² of \$15,000. Thirty days later, Bank sold the collateral to Fourth Party for \$70,000. Bank instituted a deficiency action against Debtor for \$65,000.

Issue

DID THE FORECLOSURE SALE PRICES IN CASE #1 OF \$55,000 AND IN CASE #2 OF \$15,000 CONCLUSIVELY ESTABLISH DEFICIENCIES OF \$25,000 IN CASE #1 AND \$65,000 IN CASE #2? OR MAY DEBTOR CHALLENGE THOSE SALE PRICES ON THE GROUND THAT THE FAIR VALUE OF THE COLLATERAL WAS \$70,000 AND, IN ANY EVENT, NO LESS THAN \$60,000—THEREBY REDUCING THE DEFICIENCY TO NO MORE THAN \$20,000?

22. When the secured party “bids in” the collateral it does not pay money; rather, it just allows a credit against the outstanding debt. That is called a credit bid. The same problem could arise if the sale was to a person with whom the secured party has a “relationship,” *viz.* a related party such as an insider or affiliate, or one against whom the secured party has a right of recourse. This latter group would include persons liable under a guaranty, endorsement, repurchase agreement, or the like, *i.e.* “secondary obligors.” Draft, Uniform Commercial Code Revised Article 9, Secured Transactions; Sales of Accounts and Chattel Paper § 9-102(a)(34) (Nat’l Conference of Comm’rs on Unif. State Laws, Feb. 1997) [hereinafter Feb. 1997 Draft, Art. 9], *available at* <<http://www.law.upenn.edu/library/ulc/ulc.htm>> (visited on Mar. 31, 1997); *see* RESTATEMENT OF SURETYSHIP AND GUARANTY § 1(1)(a) (1996). In this circumstance, the purchaser may pay money, or, alternatively, give the secured party a credit against a separate obligation of the secured party. This could occur at a public or private sale. *See* U.C.C. § 9-504(3) (1995) (generally, the secured party cannot be the purchaser at a private sale). The purchase price “paid” by the insider or affiliate (*see* the definitions thereof in the Bankruptcy Code, 11 U.S.C. § 101(2),(31) (1994)) may bear no relationship to the fair value of the collateral. Indeed, the problem is even more complicated in the circumstance where the purchaser is a secondary obligor who is obligated to pay a purchase price equal to the amount of the outstanding obligation, even though it is *more* than the fair value. In that instance, the secondary obligor should still be able to recover a deficiency representing the excess of the amount of that purchase price over the fair value of the collateral. *See* Rapson, *supra* note 11, at 674-80. The fair value proposal would accomplish this purpose by requiring an adjustment of the purchase price, whatever it may be, and whether it is paid by a credit bid or a payment by the secured party, insider, affiliate, or secondary obligor at a public or private sale, to reflect the fair value of the collateral at the time of disposition. *See infra* note 88 and accompanying text. The case of a secondary obligor who is obligated to pay the amount of the outstanding obligation when that amount is in excess of the fair value of the collateral, could result in a downward adjustment, thereby establishing a deficiency claim against the debtor. In almost all other cases, however, any adjustment would be upwards, reducing the deficiency claim. Absent some extraordinary circumstance, there should never be a downward adjustment when the secured party is the purchaser at the foreclosure sale.

B. Gilmore's Perspective

Professor Gilmore used a similar example that was different in some significant respects:

Let us assume that, despite notification and publicity, neither the debtor nor any other bidder appears at a public sale, held at an appropriate time and place. The secured party bids in for \$1000 the collateral which secures a \$10,000 obligation. Six months later, after having collected the \$9000 deficiency from the debtor, he resells the erstwhile collateral for \$10,000. Like any other transaction, this one could be set aside on proof of fraud—for example, when the secured party bid the collateral in for \$1000, he already had the \$10,000 resale contract in his pocket. Apart from proof of fraud, the transaction should be unassailable.²³

Gilmore's example is somewhat unrealistic in positing a situation where the secured party first collects the deficiency and subsequently resells the collateral for ten times the amount of its bid price. Furthermore, we are not told how the deficiency was collected. For example, did the debtor voluntarily pay the deficiency? Or was there a suit for the deficiency, resulting in a judgment, which the secured party was able to enforce by levy and execution upon the debtor's assets?²⁴

Although I am certainly troubled by the conclusion that “[a]part from proof of fraud, the transaction should be unassailable,”²⁵ Gilmore's example of “fraud” is revealing. He suggests that if the secured party had a “\$10,000 resale contract in his pocket” at the time of foreclosure, it would be fraud.²⁶ If the secured party, instead, had “in his pocket” appraisals or his own estimated valuation of \$10,000, would Gilmore have called that fraud? How is that significantly different? Missing from Professor Gilmore's discussion is any recognition that secured parties routinely make or obtain valuations of the collateral prior to the foreclosure sale in order to establish an upset or let go price.²⁷ This valuation is done so that the secured party will be prepared to

23. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

24. If the debtor had assets which enabled it to pay off the \$9000 debt six months later, could the debt have been paid before repossession and foreclosure?

25. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

26. *Id.*

27. Many foreclosure sales are handled by attorneys or independent repossession companies. Before holding the sale, they require instructions from the secured creditor-client as to how high they

“bid up” the collateral to a conservatively pre-determined amount before it can let the collateral go to a third-party bidder. Otherwise, the secured party will lose the meaningful benefit of the collateral.

Some secured lenders will commence the bidding by immediately going to that let go price, particularly if it is apparent that there is going to be genuine competitive bidding. But all too frequently, as Gilmore expressly recognized, “neither the debtor nor any bidder appears” even though the procedure in terms of “notification and publicity” was commercially reasonable.²⁸ In that circumstance, there is no compelling reason for the secured party to “bid in” the let go price and it may merely make a pro forma nominal or minimal credit bid to buy-in the collateral. The critical issue is whether the secured party should be able to enforce a deficiency claim based on that bid—especially if there is proof that the secured party had, or should have, established a higher valuation at the time of the foreclosure sale.²⁹

Despite the inference that can be drawn from Gilmore’s use of the word *unassailable*, I do not believe that he would have allowed Bank in Case #2 to recover a deficiency of \$65,000. It is one thing to say that the foreclosure sale itself may not be challenged if the procedure was commercially reasonable; but it is quite different to say that the amount of the bid used in calculating the deficiency may not be challenged.³⁰

should bid, if necessary, in order to protect the client’s equity in the collateral, i.e., the minimum value that the client expects to realize. This is the let go or upset price.

28. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

29. This should be readily ascertainable by discovery of the secured party’s files. If there was nothing in the file revealing the establishment of a let go or upset price, the secured party’s actions may be suspect as deviating from normal operating procedures. In some cases, it may be commercially unreasonable for a secured party to sell the collateral without having made some effort to first determine the value of the collateral. Some lenders may be concerned that the loan officer handling the account might establish too high a value for the collateral in order to screen from his superiors a greater loss. I have not seen that happen in my own experience. If, however, that is a realistic concern, the secured party may then be hard-pressed to establish a lower value for the collateral and will be unable to establish a larger deficiency. I do not consider this to be a valid objection to the fair value proposal.

30. This is basically the distinction made in the RESTATEMENT OF MORTGAGES, *supra* note 14, §§ 8.3, 8.4. Section 8.3(a) provides that “[a] foreclosure sale price obtained pursuant to a foreclosure proceeding that is otherwise regularly conducted in compliance with applicable law does not render the foreclosure defective unless the price is grossly inadequate.” *Id.* § 8.3(a). Under section 8.4, however, the debtor in a deficiency action has a right to request a determination of the “fair market value,” which, if greater than the foreclosure sale price, can be offset against the deficiency to the extent of the excess. *Id.* § 8.4(d). In revising Article 9, however, I would not equate fair value with “fair market value.” See *infra* notes 61, 63 and accompanying text.

Gilmore's rationale for his conclusion is as follows:

As the best way to produce a fair price, the Code relies on the mechanism of a public sale, notification and publicity. If the mechanism, properly operated, fails to produce any bids except the secured party's[,], a reasonable inference is that there was no value to be salvaged. It should be borne in mind that the debtor must receive notification of the proposed sale. He is in at least as good a position as the secured party to promote interest in the sale, even if he is unable to raise the money that would be needed to redeem the collateral. If he does nothing, his later allegation that the property was worth a great deal more than the secured party paid for it should be received with a degree of scepticism.³¹

Putting aside for the moment my belief that this rationale is fundamentally flawed, the "reasonable inference that there was no value to be salvaged,"³² simply does not hold up in the context of the facts in the hypothetical, or for that matter, in most Article 9 foreclosure sales resulting in the secured party buying-in the collateral. Here, the establishment of an upset or let go price in the range of \$50,000 to \$60,000 refutes any such inference—and the post-foreclosure sale for \$70,000 thirty days later confirms that refutation.

That is why I do not believe that Gilmore's statement really means that Bank would have an unassailable³³ right in Case #2 to recover a \$65,000 deficiency based on its buy-in for \$15,000. Notwithstanding Professor Gilmore's extreme reliance on a foreclosure sale that, procedurally, was commercially reasonable, he, of all people, knew that the courts would not countenance the harshness of a statutory rule that conclusively established a deficiency based upon a secured party's credit bid. Using his own phrase, the courts would find ways to "ritually disembowel"³⁴ a statute that provided for such a result.

This is so, even though the first sentence of UCC § 9-507(2) provides: "The fact that a better price could have been obtained by a sale at a different time or in a different method from that selected by the secured party is not of itself sufficient to establish that the sale was not made in a commercially

31. 2 GILMORE, *supra* note 2, § 44.6, at 1245 (footnote omitted).

32. *Id.*

33. *Id.*

34. Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 461 (1979).

reasonable manner.”³⁵

That provision deals, however, with the commercial reasonableness of the sale for purposes of determining whether a secured party has complied with the procedural requirements and it does not deal with the *calculation* of the deficiency—especially in the context of the secured party having been the purchaser. The issue being discussed in this Article assumes that the procedures of the sale have been commercially reasonable and focuses on the deficiency claim. Indeed, it is not all that clear that the present Article 9 mandates the result suggested by Gilmore. For example, courts in New Jersey and New York allow the debtor to challenge the amount of a deficiency claim based upon the bid of the secured party in buying-in the collateral.³⁶

C. *Gilmore's Reliance on Commercial Reasonableness*

Gilmore's rationale for concluding that a procedurally correct foreclosure sale—one that he describes as a “complicated ritual”³⁷—is unassailable,³⁸ was based upon his belief that the commercial reasonableness requirement would be a major improvement in foreclosure law and provide meaningful protection to debtors against abusive deficiency claims. Consider Gilmore's statement earlier in his treatise:

Sad experience has taught us that a power of sale, coupled with a right to a deficiency judgment, can be harder on the debtor than strict foreclosure ever was. The surplus to be returned to the debtor after the sale is a glittering mirage; the deficiency judgment is the grim reality. Furthermore the person who buys at the sale today, nine times out of ten, is not our hero, the good faith purchaser for value, but the holder of the security interest who pays not in cash but by a credit against the debt.³⁹

35. U.C.C. § 9-507(2) (1995).

36. See examples cited *supra* note 16.

37. 2 GILMORE, *supra* note 2, § 43.2, at 1190. In my experience, most foreclosure sales are a “ritual,” but not “complicated.” Professional secured lenders establish standard operating procedures for notice, publicity and the like, which industry practice and the courts generally accept as commercially reasonable. Frequently, foreclosure sales are held at dealer lots, at locations at or near offices of the institutional lender, and at or near sheriffs' offices. To me, many of these sales are virtually indistinguishable, conceptually and procedurally, from real estate mortgage foreclosure sales, notwithstanding the commercial reasonableness requirement for the former.

38. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

39. *Id.* § 43.2, at 1188-89.

Gilmore was convinced that “the price-determining function of the market” could be relied upon “to establish the fair value of the collateral.”⁴⁰ His faith in the elixir of commercial reasonableness reflected Gilmore’s belief that this duty was equivalent to the fiduciary obligation of the secured party to the debtor “to use his best efforts to see that the highest possible price is received from the collateral.”⁴¹ Thus, it is quite clear that Gilmore not only believed in the goal of realizing fair value, but was also convinced that the Article 9 foreclosure duty of commercial reasonableness was the best way of accomplishing that goal.

D. The Flaws in Gilmore’s Rationale

Unfortunately, Professor Gilmore’s faith in procedural commercial reasonableness as the best way “to see that the highest possible price is received from the collateral”⁴² was much too optimistic and unrealistic. Foreclosure procedures followed by most lenders are neither complicated rituals nor regarded as performance of a lender’s fiduciary obligation to the debtor.⁴³ Although as discussed below,⁴⁴ the standard of commercial

40. *Id.* § 44.6, at 1240. Indeed, Gilmore viewed the practice of giving the debtor “credit against the debt for the ‘fair value’ of the property, and not merely for the proceeds of the sale,” as part of a transition to decrees of strict foreclosure without any deficiency liability: “The best thing about the Code default provisions may be that they are open-ended enough to allow the transition to continue unimpeded.” *Id.* § 43.2, at 1189.

41. *Id.* § 44.5, at 1232-34.

Courts have long been accustomed to formulate the duty of a pledgee or mortgagee who sells collateral after default in terms of a fiduciary obligation. That standard was restated by the New York Court of Appeals in 1955 in a carefully considered opinion by Judge Desmond:

“A pledgee’s duty adequately to advertise his sale is not imposed by any statute but by ‘the general maxims of equity’ which govern pledges. . . . Equity assigns to pledgor and pledgee a trust relationship with resulting obligations on the pledgee. . . .” One of those obligations (on mortgagee and pledgee) is to “use every effort to sell the estate under every possible advantage of time, place, and publicity.” Perry on Trusts and Trustee [4th ed.] § 6020 . . . [citing *In re Kiamie*, 130 N.E.2d 745, 747 (N.Y. 1955)].

Whether the duty is phrased in terms of a fiduciary obligation or of “commercial reasonableness,” it could not be better put than in Judge Desmond’s quotation from Perry: the Code secured party, like his pre-Code counterparts, must “use every effort to sell the estate under every possible advantage of time, place and publicity.”

The facts of the *Kiamie* case afford an apt illustration of the way in which courts may be expected to apply—and, in the author’s opinion, should apply—the Code standard. . . .

The *Kiamie* case is excellent law under the Code.

Id. at 1232-34 (citations omitted).

42. *Id.* at 1234.

43. Gilmore’s excessive reliance on commercial reasonableness probably explains his view that

reasonableness may have worked in Case #1 to achieve a fair value, it clearly failed to do so in Case #2. Furthermore, Gilmore's rationale for saying that a procedurally complying, commercially reasonable sale that, nevertheless, failed to produce any bidders, should be unassailable, is flawed in at least three important respects, any of which make recovery of a \$65,000 deficiency unjustified in Case #2:

1. No recognition is given to the customary practice and procedure by secured parties of establishing upset or let go prices prior to the foreclosure sale.
2. It is *not* unusual for bidders to fail to appear at a public sale, even though Article 9's procedural requirements for "notification and publicity" have been satisfied. There are valid reasons, unrelated to procedure why prospective buyers do not appear or bid at such sales. Hence, it is *not* reasonable to infer that the collateral has "no value to be salvaged."⁴⁵
3. The notion that the defaulting debtor, who is usually financially distressed, and often in a state of managerial and emotional disarray, is "in at least as good a position as the secured party to promote interest in the sale"⁴⁶ is erroneous and unrealistic.

Point 1 has already been discussed.⁴⁷ Point 2 was the case before Article 9 and continues to be the case today. Gilmore himself acknowledged that "the person who buys at the sale today, nine times out of ten, is not our hero, the good faith purchaser for value, but the holder of the security interest who pays not in cash but by a credit against the debt."⁴⁸ In discussing the Article 9 provisions he candidly acknowledged:

noncompliance should result in the loss of any right to a deficiency claim, i.e., the "absolute bar rule." See 2 GILMORE, *supra* note 2, § 44.9.4, at 1264. "We may conclude that the secured party's compliance with the default provisions of Part 5 . . . is a condition precedent to the recovery of a deficiency." *Id.* This view has already been rejected by the Article 9 Drafting Committee for commercial transactions. The Drafting Committee did not make a decision with respect to consumer transactions and, apparently, will let the individual states decide which rule to adopt. Draft section 9-625(2) states the rebuttable presumption rule for commercial transactions. Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-625(2)(B); see *infra* notes 66-67.

44. See *infra* notes 61-63 and accompanying text.

45. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

46. *Id.*

47. See *supra* notes 25-29 and accompanying text.

48. 2 GILMORE, *supra* note 2, § 43.2, at 1188-89.

At a “public sale,” it may be hoped, there will be that lively concourse of bidders which will protect the secured party from his own weakness and drive the price up to those Himalayan peaks of fair value and true worth. It may be hoped but the hope will almost certainly be disappointed. The concourse of bidders at the typical foreclosure sale, be it ever so “public,” is apt to be about as lively as a group of mourners at a funeral. Nevertheless, the Article 9 draftsmen, who showed themselves to be imaginative and resourceful in many situations, were tradition-bound in this one.⁴⁹

In that context, I am perplexed how Gilmore’s analysis of the “really hard problem,” where the secured party bids in for \$1000 and resells the collateral six months later for \$10,000, could permit him to make “a reasonable inference . . . that there was no value”⁵⁰ at the time of the foreclosure sale. That is clearly wrong; there are ready explanations why bidders do not show up at Article 9 foreclosure sales even though the collateral *does* have value. Two examples will suffice.

First, take the common case where a bank conducts a foreclosure sale of a used car. Retail consumer buyers are not likely to appear for the simple reason that they can buy the same model and year car from a dealer, who will not only provide servicing, but may offer express used car warranties of condition and performance for a limited period. Financial institutions will not do so and will even disclaim any possible implied warranties of merchantability or fitness, even though the Code already acknowledges that there are no such warranties because such institutions are not usually “merchants” in the business of selling cars.⁵¹ It is plainly unreasonable, therefore, to infer that the car has no value and to base a deficiency claim on that inference. The bank will bid in the car and then resell it to a dealer at a private sale—usually for its wholesale value as adjusted by its present condition. The dealer will fix up the car and sell it at retail, often for a profit—which it should be entitled to do.

Second, consider the example of a fifteen-year-old airliner which has been repossessed by a finance company lender from a bankrupt airline. Assume that there is an outstanding loan of ten million dollars and the plane requires one million dollars in repairs. In recent years, the market had been very

49. *Id.* § 44.6, at 1242.

50. *Id.* § 44.6, at 1245.

51. *See* U.C.C. §§ 2-104 cmt. 2 (1995); *id.* § 2-314.

limited for some classes of these airplanes, but an expectation existed that “start-up” airlines would in the near future buy or lease these planes—an expectation that has in fact been realized. Following repossession, the lender determined that the plane had a minimum value of four million dollars in its unrepaired condition. After being unable to find a buyer for a private sale, the lender held a public sale that procedurally was commercially reasonable. No bidders appeared and the lender bid in the plane for \$100,000. Surely it would be wrong to infer that the plane had no value, or a value of only \$100,000, and to rely upon that figure in determining a deficiency. At the very least, the airliner with its four jet engines had a scrap value well in excess of that amount. Even if the lender had increased its credit bid tenfold to \$1,000,000, that amount would still be unreliable for purposes of accurately calculating a deficiency.

Point 3 is also wrong. Defaulting debtors often are “not in at least as good a position as the secured party to promote interest in the sale.”⁵² Debtors fail and go into default for any number of reasons, including drastic downturns in personal, financial, or economic conditions which do not necessarily reflect bad faith by the debtor. Under those circumstances, distressed debtors have things on their minds other than drumming up interest in a foreclosure sale for their repossessed property. Moreover, common sense suggests that if these debtors were in a position to find third party buyers, some might have done so before going into default, so as to prevent the calling of the loan and repossession of the collateral. Gilmore’s statement to the contrary is surprisingly naive and unrealistic.

E. Calculating Deficiency Claims

Reiterating what was said earlier,⁵³ in discussing Cases #1 and #2 the issue is *not* whether the foreclosure sale and resultant purchase should be upset. If the sale satisfies the procedural requirements of commercial reasonableness, it should stand (i.e., be unassailable), and the purchaser, whether it be Third Party in Case #1 or Bank in Case #2, should be entitled to own the property free of any claims thereto.⁵⁴ The critical question here is whether the secured party may also enforce a deficiency claim based upon the amount of the bid.

For me, the answer is clear in Case #2. Bank should not be able to recover

52. 2 GILMORE, *supra* note 2, § 44.6, at 1245.

53. See *supra* note 21, 30 and accompanying text.

54. *Id.*

a \$65,000 deficiency in Case #2. Case #1, however, is more difficult, requiring analysis of two separate issues. First, whether Debtor should be able to even *contest* the amount of the deficiency claim of \$25,000, and, second, if the challenge can be made, how should it be resolved?

Debtor will, of course, be motivated to challenge the deficiency claim because of the sale, thirty days later, for \$70,000 (i.e., \$15,000 more than Third Party's successful bid of \$55,000 at the foreclosure sale). It will contend that the deficiency is no more than \$10,000. On the other hand, Bank will argue that Debtor should not even be permitted to challenge the deficiency claim. Indeed, from the perspective of efficiency and limitation of transaction costs, it is tempting to say that if (i) the procedural requirements of commercial reasonableness have been satisfied and (ii) the purchaser (Third Party) at the foreclosure sale was an independent third party, then no challenge should be allowed in Case #1. That contention and result, based upon the particular facts in Case #1, certainly has superficial appeal.

The problem with that approach, however, is that it pre-judges the result and denies Debtor a right to prevent the entry of a judgment against it. What if Third Party had, instead, purchased the property for \$35,000 and Bank was seeking to enforce a deficiency claim of \$45,000? In that circumstance, it clearly would be unjust to deny Debtor its day in court. Debtor could mount an effective challenge based upon the following: (i) Bank's pre-foreclosure evaluation, (ii) the \$50,000 upset price, and (iii) the subsequent sale thirty days later for \$70,000. In my view, economic efficiency should, as a general rule, give way to individual justice and equity, and debtors should not be denied the right to *contest* the amount of the deficiency claims asserted against them, even though many of these contests should and will end on a motion for summary judgment by the secured party. It is a mistake to assume that economically efficient rules that shield potentially questionable conduct from challenge, unless outrageous or egregious, are necessarily helpful to the business of providing secured credit.⁵⁵ The *resolution* of those challenges,

55. The risk of being challenged has an overall beneficial effect in that it serves as a deterrent to arrogant behavior and unsound lending practices and procedures. This is not the view of some of the current revisors to the UCC, who stress having predictable and certain rules that are not susceptible to judge-made exceptions. For example, consider the uneasy tone of the grudging mini-concession in Comment 9 to UCC section 9-115. This was only written after comments were received by critics, including myself, who were concerned that the "protected purchaser" and "control priority" concepts were too broad and that there needed to be a safety valve against behavior that was aberrant or otherwise not in good faith because contrary to "reasonable commercial standards of fair dealing" under UCC section 1-203.

however, is a different matter.

F. Applying Fair Value

The issue then becomes whether the foreclosure sale price should be adjusted in calculating the deficiency, viz., the \$15,000 credit bid by Bank in Case #2 and Third Party's bid of \$55,000 in Case #1. The goal should be to accomplish what Gilmore optimistically thought would be achieved with the commercial reasonableness standard—the realization of fair value.⁵⁶ As evidenced by Case #2, however, that standard does not necessarily accomplish the goal. To apply the statute in such a way as to allow Bank to recover a deficiency of \$65,000 in Case #2 would be a perversion of that

9. **Relation to other law.** Section 1-103 provides that “unless displaced by particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions.” There may be circumstances in which a secured party's action in acquiring a security interest that has priority under this section constitutes conduct that is wrongful under other law. Though the possibility of such resort to other law may provide an appropriate “escape valve” for cases of egregious conduct, care must be taken to ensure that this does not impair the certainty and predictability of the priority rules. Whether a court may appropriately look to other law to impose liability upon or stop a party from asserting its Article 9 priority depends on an assessment of the party's conduct under the standards established by such other law as well as a determination of whether the particular application of such other law is displaced by the UCC.

....

In determining whether it is appropriate in a particular case to look to other law, account must also be taken of the policies that underlie the commercial law rules on securities markets and security interests in securities. A principal objective of the revision of Article 8 and corresponding provisions of Article 9 is to ensure that secured financing transactions can be implemented on a simple, timely, and certain basis. One of the circumstances that led to the revision was the concern that uncertainty in the application of the rules on secured transactions involving securities and other financial assets could contribute to systemic risk by impairing the ability of financial institutions to provide liquidity to the markets in times of stress. The control priority rule is designed to provide a clear and certain rule to ensure that lenders who have taken the necessary steps to establish control do not face a risk of subordination to other lenders who have not done so.

The control priority rule does not turn on an inquiry into the state of a party's awareness of potential conflicting claims because a rule under which a party's rights depended on that sort of after the fact inquiry could introduce an unacceptable measure of uncertainty. If an inquiry into awareness could provide a complete and satisfactory resolution of the problem in all cases, the priority rule of this section would have incorporated that test. The fact that it does not necessarily means that resort to other law based solely on that factor is precluded, though the question whether a control secured party induced or encouraged its financing arrangement with actual knowledge that the debtor would be violating the rights of another secured party may, in some circumstances, appropriately be treated as a factor in determining whether the control party's action is the kind of egregious conduct for which resort to other law is appropriate.

U.C.C. § 9-115 cmt. 9 (1995). Professor Mooney contributed substantially to this Comment.

56. See *supra* notes 40-41 and accompanying text.

objective. Moreover, application of the standard of commercial reasonableness is much too problematic, even more so than fair value. Disputes about the commercial reasonableness of the procedures followed by the secured party have turned out to be one of the most litigated issues under the Code.⁵⁷

Accordingly, it makes sense to go to the heart of the issue and amend Article 9 to straightforwardly require that there be fair value. As previously indicated, the fair value rule is the majority rule for deficiency actions in real estate mortgage law⁵⁸ and was the rule in some states for personal property secured transactions prior to the enactment of Article 9.⁵⁹ The essence of the rule is basic justice and fairness—"the broad equitable concept that a mortgagee is not entitled to recover more than the full amount of the mortgage debt."⁶⁰ One should be hard-pressed to quarrel with that proposition.

The fair value rule is not necessarily synonymous with "fair market value" because fair value recognizes that foreclosure sales are usually under distress conditions and made in a forced sale marketplace. Moreover, there does not have to be one certain value, but, instead, a *range* of values, and a credit against the outstanding obligation of an amount within that range fulfills the equitable concept inherent in fair value. It is a quest for fairness and reasonableness, not certainty. The adage that the "best settlement is one where neither party is happy with the result" is useful here. Phrases such as "fair foreclosure value" or "reasonable foreclosure value" could just as easily be used because they carry the same connotation and implement the same concept. A helpful analogy in a related area is the change from "fair consideration" to "reasonably equivalent value" in the fraudulent conveyance and transfer laws.⁶¹ Let us examine how fair value would be determined in Cases #1 and #2.

The initial inquiry concerns the \$70,000 resale to Fourth Party thirty days after the foreclosure sale. The resale is certainly an evidentiary factor in determining value, but should not be conclusive. We do not know whether

57. Robert M. Lloyd, *The Absolute Bar Rule in UCC Foreclosure Sales: A Prescription for Waste*, 40 UCLA L. REV. 695, 699 n.22 (1993).

58. RESTATEMENT OF MORTGAGES, *supra* note 14, § 8.4.

59. See examples cited *supra* note 15.

60. 79-83 Thirteenth Ave., Ltd. v. De Marco, 210 A.2d 401, 406 (N.J. 1965).

61. Compare UNIF. FRAUDULENT CONVEYANCE ACT §§ 3-4 (1918), 7A U.L.A. 427, 448-49, 474 (1985), with UNIF. FRAUDULENT TRANSFER ACT §§ 4-5 (1984), 7A U.L.A. 639, 652-53, 657 (1985).

there were any repairs or improvements to the collateral in that period or the cost of any that may have been made. In Case #1, Third Party may have had more marketing capability than Bank, e.g., it may have been a merchant or dealer. Nor do we know anything about the marketplace conditions in which Third Party was selling other than that the conditions were probably not as distressed as the foreclosure sale. If Third Party was a dealer, the sale could be to a retail market. Even if not a dealer, Third Party might still be in a position to make a profit on a resale. There should be no impediment—legal, policy, moral or ethical—to Third Party making a profit on the resale. We also need to know something about Fourth Party and whether there were any special circumstances which might explain the \$70,000 price.

In contrast, the \$70,000 resale price in Case #2 would be a weightier factor because it raises the immediate question of why Bank did not, or was not able to, negotiate a private foreclosure sale to Fourth Party thirty days earlier.⁶² Bank may well have had a reasonable explanation which it should be allowed to give. The fact that the \$70,000 resale price exceeded the pre-foreclosure valuation range of \$50,000 to \$60,000 is another factor to be considered in determining fair value. But, there also needs to be information on how that range was determined and the reliability of that determination. In that connection, Bank established its let go price conservatively at the low end of that range. Generally, that should not be viewed as an unreasonable decision on Bank's part.

Obviously, the range and let go price are critical factors in Case #2 in contrast to Bank's credit bid of \$15,000. There needs to be an explanation of the basis for that bid. It seems almost certain that the \$15,000 bid should be adjusted upwards. Unless the Bank can establish that the \$50,000 to \$60,000 range was mistaken or excessive, the upward adjustment should be to at least an amount that falls within that range. If the \$50,000 let go price was reasonable, that amount could be used, thereby resulting in a deficiency of \$30,000. Absent a satisfactory explanation of why the Bank could not have made that sale thirty days earlier, there could even be a higher adjustment to the \$70,000 resale price, reducing the deficiency to \$10,000.

The circumstances of Case #1 call for a different analysis which could well lead to a different result. There, Bank let the property go to Third Party for \$55,000. If Third Party was truly an independent party, the sale for that

62. Private foreclosure sales to parties with whom the secured party has a relationship should also be subject to the fair value rule. *See supra* note 22.

price lends great credence to the \$50,000 to \$60,000 valuation range and the \$50,000 let go price. This factor weighs heavily in Bank's favor and, notwithstanding the \$70,000 resale price, militates against penalizing Bank by a reduction of the \$25,000 deficiency claim. Even if, as in Case #2, the \$70,000 price paid by Fourth Party actually represents the fair market value of the property, the \$55,000 amount of the foreclosure sale price paid by Third Party constitutes almost eighty percent of that fair market value and could be justified as the fair value, fair foreclosure value, or reasonable foreclosure value for purposes of calculating the deficiency.⁶³ Thus, there would be no adjustment and the deficiency would remain at \$25,000. This could be determined on a motion for summary judgment.

G. *The Fair Value Proposal*

When I first advanced the fair value proposal in connection with the pending revision of Article 9, I took the position that it should be applicable to all deficiency claims, whether consumer or commercial. Borrowing from the fair value deficiency statutes in effect in numerous jurisdictions governing real estate mortgage deficiency actions,⁶⁴ I suggested that UCC section 9-504 be amended to require a credit in calculating deficiency claims:

63. To reiterate, fair value can be different than fair market value. *See supra* note 61 and accompanying text. This is similar to the approach followed by some courts in determining whether a transfer was fraudulent under section 548 of the Bankruptcy Code for failure to satisfy the reasonably equivalent value requirement. *E.g.*, *Bundles v. Baker*, 856 F.2d 815, 824 (7th Cir. 1988) (reasonable equivalence should be determined on a case-by-case basis that starts with fair market value but accords "respect" to the foreclosure sale proceedings); *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 203 (5th Cir. 1980) (suggesting mechanical application of the threshold requirement that the transfer bring at least 70% of the market value of the property). These cases were, of course, subsequently rejected by the 5-4 decision of the U.S. Supreme Court in *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757 (1994), which held that reasonably equivalent value is conclusively established by the price paid at a noncollusive, lawfully conducted, and procedurally complying real estate mortgage foreclosure sale. As of the writing of this Article it is not clear whether the decision is applicable to an Article 9 foreclosure sale. In any event, I believe that Justice Souter's dissent was better reasoned and more realistic and that much of its reasoning can and should be applied to the issue at hand:

[T]he *Durrett* "rule" . . . claims only to be a description of what foreclosure prices have, in practice, been found "reasonable[e]," and as such, it is consistent . . . with the textual directive that one value be compared to another . . . To the extent, moreover, that *Durrett* is said to have announced a "rule," it is better understood as recognizing a "safe harbor" or affirmative defense for bidding mortgagees or other transferees who paid 70% or more of a property's appraised value at the time of sale.

Id. at 1773 n.13.

64. RESTATEMENT OF MORTGAGES, *supra* note 14, § 8.4.

The existence and amount of a deficiency shall be determined by allowing a credit against the indebtedness of an amount equal to what would have been realized from a sale or disposition that was conducted in a commercially reasonable manner (subsection (2) of Section 9-507), irrespective of whether the actual sale or disposition was so conducted and irrespective of the price obtained.⁶⁵

The phrase “would have been realized from a sale or disposition that was conducted in a commercially reasonable manner” was borrowed directly from the Reporters’ formulation of the “rebuttable presumption rule” in Draft section 9-625.⁶⁶ That provision limits a debtor’s liability when the foreclosure conducted by the secured party has not complied with the procedural requirements of commercial reasonableness. The rule is that noncompliance results in the secured party being unable to enforce a deficiency claim unless it can sustain the burden of factually proving that what “would have been realized” from a complying sale would still have been less than the amount of the outstanding obligation.⁶⁷ Application of that rule necessarily involves a determination of the value of the collateral at the time of the foreclosure sale or disposition. In my view, that determination involves essentially the same

65. Rapson, *supra* note 11, at 686-87.

66. Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-625(2). Here, the issue is whether a secured party who has not satisfied the commercial reasonableness requirements in conducting a foreclosure sale can still enforce a deficiency claim. In contrast to the absolute bar rule which precludes such a claim, the rebuttable presumption rule allows the secured party to enforce such a claim if and to the extent it can sustain the burden of proving that the value of the collateral was, in fact, less than the amount of the outstanding debt. The formulation in February 1997 Draft, section 9-625 provides:

In an action in which the amount of a deficiency or surplus is in issue the following rules apply:

....

(2) . . . the liability of a debtor or a secondary obligor for a deficiency is limited to an amount by which the sum of the secured obligation, expenses, and attorney’s fees exceeds the greater of the [actual] proceeds of the collection, enforcement, disposition, or acceptance or the amount of proceeds that would have been realized had the noncomplying secured party proceeded in accordance with [Section 9-607, 9-608, 9-609, 9-610, 9-611, 9-612, 9-613, or 9-614] [the provisions of this part relating to collection, enforcement, disposition, or acceptance]. However, the amount that would have been realized is equal to the sum of the secured obligation, expenses, and attorney’s fees unless the secured party meets the burden of establishing that the amount is less than that sum.

Id. (brackets in original). Both Alternative A (which contains a separate absolute bar rule for consumer secured transactions) and Alternative B (which provides a rebuttable presumption rule for all transactions) read the same on this point.

67. *Id.* This is in sharp contrast to the absolute bar rule which Gilmore concluded was the consequence of noncompliance—and which has been rejected by the Article 9 Drafting Committee at least for commercial transactions. *See supra* note 43.

elements of proof required to determine fair value. It is the reverse side of the same coin—in both instances the secured party is required to sustain the burden of establishing value in order to recover a deficiency.

The proposal was formulated in those terms because it was conceptually consistent with the rebuttable presumption rule which had already been approved by the Article 9 Drafting Committee. Inasmuch as the Drafting Committee was prepared to adopt a rule which, as a practical matter, required a determination of fair value by a fact-finder, why not use that concept whenever the secured party sought to enforce a deficiency claim and obviate the need to litigate commercial reasonableness? The rebuttable presumption rule is applicable to the circumstance where there is non-compliance with the requirements for commercial reasonableness; the proposal I advanced made commercial reasonableness irrelevant for purposes of enforcing a right to recover a deficiency and the calculation thereof. There would, nevertheless, still be sanctions, albeit different, for non-compliance.⁶⁸

II. THE DELIBERATIONS OF THE ARTICLE 9 DRAFTING COMMITTEE

The initial reaction of the Drafting Committee was not favorable.⁶⁹ The Reporters and most members were concerned that too many deficiency claims would be contested and result in “valuation hearings.” For the most part, there was a willingness to accept the view that if the procedural requirements of commercial reasonableness were satisfied, the amount of the bid, no matter by whom or how low, conclusively established the deficiency.⁷⁰ A few members, however, were willing to consider a fair value rule where the secured party had bid in the property with a nominal or

68. In essence, the secured party would be liable for damages resulting from non-compliance. UCC Draft section 9-624(b) provides:

A secured party is liable for damages in the amount of any loss caused by a failure to comply with this article. Except as otherwise provided in Section 9-627, a person that, at the time of the failure, was a debtor, was a secondary obligor, or held a security interest in or other lien on the collateral has a right to recover damages for its loss under this subsection. A debtor whose deficiency is eliminated under Section 9-625 may recover damages for the loss of any surplus, but a debtor or consumer obligor whose deficiency is eliminated or reduced under Section 9-625 may not otherwise recover under this subsection for noncompliance with [Section 9-607, 9-608, 9-609, 9-610, 9-611, 9-612, 9-613, or 9-614] [the provisions of this part relating to collection, enforcement, disposition, or acceptance].

Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-624 (brackets in original).

69. See *infra* notes 78-81 and accompanying text.

70. In other words, Bank would be entitled to recover a \$65,000 deficiency claim in Case #2 which Debtor could not successfully challenge. See *supra* note 22.

disproportionately low bid.⁷¹

At this point, it is useful to retrace and follow in greater detail the path of the fair value proposal made to the Article 9 Drafting Committee to see where it may lead.

A. *The Permanent Editorial Board Study Committee*

The proposed revision of Article 9 commenced in 1990 with the establishment of a Study Committee of the Permanent Editorial Board for the UCC charged with recommending whether Article 9 and related provisions of the UCC were in need of revision. The Study Committee met seven times from 1990 to 1992 and issued a Report in December 1992 which made wide-ranging recommendations for revision.⁷²

Although the Study Committee Report deals extensively with the subject of enforcement and contains important recommendations affecting the default provisions in Part 5 of Article 9, the calculation of deficiency actions and the fair value proposal are never discussed. Indeed, that topic was never on the agenda for the Study Committee and never mentioned in the meetings. No one else brought up the issue, and I did not realize that I would have to make it an issue until it was too late to bring it before the Study Committee. My article discussing deficiency actions and advancing the fair value proposal⁷³ did not appear until late 1992, after the Study Committee's last meeting. I did, however, indicate to the Reporters for the Study Committee (who became the Reporters for the Drafting Committee) that I intended to raise the issue in the Drafting Committee. Accordingly, the Study Committee Report, in recommending adoption of the rebuttable presumption rule as Article 9's baseline rule, contained the following footnote:

The statement in the text assumes that deficiencies will continue to be determined by deducting from the secured debt an amount equal to the net proceeds of a disposition that complies with Part 5. *See* § 9-504(1),

71. In response to the criticism that the language of my proposed formulation might not be effective in that circumstance because what "would have been realized" from a commercially reasonable sale was exactly that same nominal or low bid, addition of the following sentence would resolve that "problem": "In making that determination, it shall be assumed that the sale or disposition was to a purchaser other than the (i) secured party or (ii) an affiliate or insider of the secured party."

72. PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT (Dec. 1, 1992) [hereinafter STUDY COMMITTEE REPORT].

73. Rapson, *supra* note 11.

(2). The Committee did not consider whether to change the means by which a deficiency is determined; the Drafting Committee may wish to do so.⁷⁴

Why was this issue not considered by the Study Committee? In retrospect, notwithstanding the excellence and expertise of the Reporters and the other Study Committee members, none were consumer advocates or had extensive litigation background on behalf of consumers or business debtors where the issue arises most frequently. As a consequence, the principal focus of the Study Committee was on business credit transactions:

Perceived problems relating to business credit transactions were the principal impetus for the Committee's study, and its recommendations reflect these concerns. However, the Committee believes that much work remains to be done to evaluate the Committee's recommendations from the consumer-protection perspective and to identify additional consumer protection issues related to secured credit. Efforts are under way to organize a task force to pursue these projects. The Committee recognizes that revision of Article 9 might or might not be the appropriate method of addressing a particular law reform in this context.⁷⁵

Although I have been a commercial litigator and handled numerous deficiency actions, most of that experience was in New Jersey and New York where courts apply the fair value rule.⁷⁶ I did not learn that it was not the rule in other states or that some of my colleagues on the Study Committee opposed the concept until after I wrote the *Idaho Law Review* article.⁷⁷ Unfortunately, by then it was too late for the Study Committee to consider the issue. It would have to be brought before the Drafting Committee.

B. The Drafting Committee in 1993 and 1994: Opposition

In early 1993, the Article 9 Drafting Committee held an organizational meeting at which it was decided to deal initially with enforcement upon default under the Part 5 provisions. During that meeting, I urged that the calculation of deficiencies, including the fair value proposal, be considered.

74. STUDY COMMITTEE REPORT, *supra* note 72, at 201 n.7.

75. *Id.* at 3 n.9.

76. See examples cited *supra* note 16.

77. Rapson, *supra* note 11.

At first, that suggestion received no support from the Reporters or the other Drafting Committee members—but, fortunately, one member, Dale Higer, spoke up and said: “I’d like to hear more about that proposal.” Mr. Higer, an experienced real estate attorney in Idaho, was already familiar with the fair value rule in the real estate mortgage context.⁷⁸ His willingness to consider the issue was an important development.

To its credit, the Drafting Committee then proceeded to extensively consider the issue. Consumer advocates regularly attended the meetings and vigorously recounted their problems with the enforcement of deficiency claims and described perceived abuses. Although they had their own agenda and recommendations for dealing with the issue,⁷⁹ they expressed general support for the fair value approach. As a result, the issue was thoroughly discussed and debated at meetings in 1993 and 1994. The report of the March 5-7, 1994 meeting made by the advisor to the Drafting Committee from the American Bar Association Section of Business Law reflected the continued negative reaction of most of the Drafting Committee:

Measurement of Deficiency Claim. The persons present considered at length the important question of how to measure the deficiency that a secured party may recover after it has conducted a *complying* disposition under UCC § 9-504. The draft provides that the secured party is entitled to a deficiency equal to the excess of its secured obligation over the *actual* proceeds of the disposition. The discussion considered whether the secured party’s deficiency claim should be limited to the difference between its secured obligation and the “fair value” of the collateral, at least where the secured party purchases at the sale. After extended discussion, the position of the draft was upheld.⁸⁰

Although the Drafting Committee was largely opposed to a general rule requiring a fair value determination in deficiency claims, a minority was more supportive of the concept in the limited context “where the secured party

78. See IDAHO CODE § 6-108 (1990) (uses “reasonable value”).

79. E.g., Gail Hillebrand, *The Redrafting of UCC Articles 2 and 9: Model Codes or Model Dinosaurs?*, 28 LOY. L.A. L. REV. 191, 201-11 (1994); Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B and 9 Be Fair to Consumers?*, 75 WASH. U. L.Q. 69, 133-39 (1997); David M. McMahon, *Commercially Reasonable Sales and Deficiency Judgments Under U.C.C. Article 9: An Analysis of Revision Proposals*, 48 CONSUMER FIN. L.Q. REP. 64 (1994).

80. Steven O. Weise, *Report: Second Meeting of Article 9 Drafting Committee*, 1994 A.B.A. SEC. BUS. L. REP. 1, 3 (footnote omitted) (on file with the *Washington University Law Quarterly*).

purchases at the sale,” i.e., Case #2.⁸¹ In addition, there was some recognition that a special rule might be appropriate in consumer cases.

C. The Drafting Committee in 1995 and 1996: Progress

In the meeting of June 9-11, 1995, the issue again came up, primarily because of a letter from Professor Luize Zubrow summarizing an article in which she recommended that a foreclosing creditor have a fiduciary duty to the debtor “to maximize collateral disposition revenue for the benefit of the debtor.”⁸² Interestingly, no mention was made of Professor Gilmore’s view that the commercial reasonableness standard was already the conceptual equivalent of a fiduciary obligation.⁸³ The meeting also discussed my proposal that fair value should at least be applicable to the circumstance where the secured party bids in for a nominal value. The report of the ABA advisor reflected that the Drafting Committee, although opposed to the fiduciary duty idea, significantly moderated its prior opposition to the fair value concept and made a decision to deal meaningfully with the issue:

Fiduciary Duties? The materials included a submission to the Reporters and the Drafting Committee suggesting that Article 9 should state that a secured party owes a fiduciary duty to the debtor in connection with foreclosure sales.

This arises out of a concern that a secured party might not have sufficient incentive under existing rules to seek to obtain the best possible price at a foreclosure sale. This might occur where the collateral has a value significantly in excess of the amount owed.

There was general agreement that the secured party should not have a fiduciary duty to the debtor in this context and that the principal problem, in non-consumer transactions, related to foreclosure sales to the secured party. There was agreement that any “solution” should

81. See *supra* note 22 and accompanying text.

82. Letter from Prof. Luize E. Zubrow, George Wash. Univ., Nat’l Law Ctr., to Prof. Charles W. Mooney, Jr., Univ. of Penn. Law Sch. (Mar. 21, 1995) (on file with the *Washington University Law Quarterly*) (presenting the ideas in Luize E. Zubrow, *Rethinking Article 9 Remedies: Economic and Fiduciary Perspectives*, 42 UCLA L. REV. 445 (1994)). The fact that neither Professor Zubrow, me, nor anyone else on the Drafting Committee mentioned Gilmore’s view that commercial reasonableness imposed a duty akin to that of a fiduciary, supports the conclusion that his optimism about what would be accomplished under that standard has not come to fruition.

83. 2 GILMORE, *supra* note 2, § 44.5, at 1232-34; *supra* note 41.

address this problem with “special treatment” without imposing a “fiduciary” structure.

The Drafting Committee agreed by a wide margin to ask the Reporters to explore language affecting the calculation of deficiencies when the secured party buys the collateral.⁽⁶³⁾

(63) The materials contained exchanges of letters and memos reporting on an ongoing dialogue on how to calculate a deficiency following a complying sale. This concern was dealt with in this vote for further study.⁸⁴

That request made to the Reporters in June 1995 was not immediately acted upon. This was primarily because of developments which took place the following month at the Annual Meeting of the National Conference of Commissioners on Uniform State Laws. A general question arose concerning the extent to which the UCC should contain special provisions dealing with consumer issues. As a result, consumer subcommittees were appointed to make recommendations on this critical issue to the Drafting Committees then working on the revisions of Articles 2 and 9, respectively. The Article 9 subcommittee was chaired by Professor Marion Benfield.⁸⁵ Inasmuch as the subject of deficiency claims was one of the major issues to be confronted by this subcommittee, the Reporters understandably decided to await its report before implementing the June 1995 request of the Drafting Committee.

In May 1996, the Benfield Subcommittee submitted its report. It deals extensively with the deficiency claim issue, stating in pertinent part as follows:

. . . 3) Deficiency after foreclosure sale purchase by 1) secured party, 2) party against whom secured party has recourse, or 3) party related to the secured party.

Consumer representatives are concerned that a purchase by any of the parties described above will not be at a price which reflects the

84. Steven O. Weise, *UCC Article 9 Revisions: Report on June '95 Meeting of Drafting Committee*, 1995 A.B.A. SEC. BUS. L. REP. 1, 15 (on file with the *Washington University Law Quarterly*).

85. Professor Benfield is a member of the Permanent Editorial Board for the UCC and the faculty of Wake Forest University School of Law. The other members of this Subcommittee (“the Benfield Subcommittee”) included Henry M. Kittleson, Esq. of Lakeland, Florida; Sandra Stern, Esq. of New York City; and Professor Neil Cohen of the Brooklyn Law School.

reasonable foreclosure value of the collateral . . . If the secured party, a person who is liable to the secured party for the unpaid debt (“recourse party”), or a person who is under substantial common ownership with the secured party (“related party”) can buy at the foreclosure sale, there is a positive incentive for them to buy at below the fair foreclosure value of the collateral. In all three cases, the actual “price” paid at the foreclosure sale is economically irrelevant to them except as it fixes the amount of deficiency. The lower the foreclosure sales price paid, the larger the deficiency which may be recovered from the debtor. And there is an opportunity for the secured party, recourse party, or related party to sell the collateral at a price which nets them more, sometimes substantially more, than the price they bid at the foreclosure sale.

Various consumer representatives have made different suggestions regarding how the possibilities for abuse might be dealt with in the statute. Among those suggestions have been: (1) deny the secured party the right to buy at its own foreclosure sale, or deny a right to deficiency if it does buy; (2) retain the present 9-504(5) rule under which, it is assumed, a sale to a recourse party cannot be an Article 9 sale fixing the deficiency; (3) subject sales to the secured party, recourse party, or related party to special scrutiny if a deficiency is sought based on the price received at the foreclosure sale . . .

. . . .

Alternatives:

Since three different situations are involved which present Article 9 treats differently, the possible alternatives are somewhat complicated.

(a) prohibit any of the three parties from buying at the foreclosure sale

(b) prohibit any of the three parties from buying at private sales, but permit them to buy at public sales

(c) retain the rules of Present Article 9, with the result that transfers (sales) to recourse parties are not Article 9 foreclosure sales, secured parties can by [sic] at public sales, and related parties are . . . able to buy at private foreclosure sales except to the extent that a court may treat a related party as being the same as the secured party.

(d) Subject to special higher scrutiny the price received and other

aspects of the foreclosure sale if the purchaser at the sale is the secured party, a recourse party, or a related party. Under this alternative, the Drafting Committee should decide whether any of the parties can purchase at a private sale.

Subcommittee recommendation:

Adopt alternative d and direct the reporters to draft a provision subjecting such sales to special scrutiny as stated in the 4th alternative. In drafting the reporters should consider the discussion in this memorandum on the issue, but should not be limited to the solutions mentioned as possibilities in that discussion.

Reason: Despite the incentives to a secured party to buy at below reasonable foreclosure value, Present and Committee Draft Article 9 permit the secured party itself to buy at its own public foreclosure sale, but not at its own private sale. The underlying assumption of that rule is that the requirement of publicity and . . . [the other] requirements of a commercially reasonable public sale (reasonable time and place[] etc.) provide protection against a purchase by the secured party at less than reasonable foreclosure value. We reject the idea that the secured party should be prohibited from buying at its own public sale. We doubt that there is any assurance that imposing restrictions on the creditor's ability to buy will increase the price received on foreclosure in the normal case. It is true that creditors often buy at the foreclosure sale and it is also true that foreclosure sales often bring prices which are disappointingly low. The Code's requirement that the sale be commercially reasonable is intended to secure a reasonable price at foreclosure. We believe that the commercially reasonable requirement is a great improvement over the older statutes which specified the details of the sale, and we also believe that having the creditor as an available bidder at a public sale increases the number of buyers by one and that is a good thing. Abuses of that right are better dealt with by an attack on the sale as proposed in Subcommittee alternative 4. . . .

. . . .

A third possible way to protect against inflated deficiencies if the secured party, a recourse party, or related party buys at the foreclosure sale, is to subject to higher than usual scrutiny the price received and

other aspects of the sale. For example, the secured party might be able to measure the deficiency by the price received only if a special showing is made that actual bona fide offers were received from unrelated prospective buyers, or that bona fide efforts to secure fair foreclosure value at the foreclosure sale were made. Under such a rule, if the secured party does not meet the higher standard of proof as to the reasonableness of the price received, or as to the efforts made in the sale to secure a reasonable price, the secured party, even though it had a commercially reasonable sale, would not be able to use the sale price to measure the deficiency.

It is perhaps relevant to the Drafting Committee thinking on the issues involved here that The Restatement of the Law of Property, (Mortgages), Tentative Draft No. 5, Section 8.4, (approved by the American Law Institute this May) provides that in all actions for deficiency after a real estate mortgage foreclosure, the debtor may request that the fair market value of the collateral as of the date of foreclosure be determined. If such a request is made, any deficiency is based on the difference between the debt and the fair market value. But if no request is made for that determination, the deficiency is the difference between the foreclosure sales price and the debt. That rule is supported by statutory or judge made law in about half the states which apply to some or all real estate mortgage foreclosures.

Application of a fair market value test for deficiency recovery in all Article 9 transactions, even all consumer transactions, is probably not justified. Deficiency claims are likely to be smaller in consumer personal property transactions. Further, the Article 9 requirement that foreclosure sales be commercially reasonable protects against unreasonably low foreclosure sale prices. In contrast, the typical real estate foreclosure statute imposes judgment-sale-like procedures on real estate foreclosures which make it very unlikely that the real estate will bring a reasonable market price. Also, in real estate transactions it is much more likely that the mortgagee will bid in at the sale.

However, in consumer secured transactions in which the secured party, a recourse party, or a related party, buys at the foreclosure sale, it may be reasonable to require the person suing for a deficiency, on demand of the debtor, to make a special showing as to the reasonableness of the price received. In the absence of that proof,

reasonable foreclosure value of the collateral might be the basis on which to determine the amount of the deficiency.

The Subcommittee has not fully considered possible methods, other than . . . those mentioned here, by which to protect against self-dealing in the three situations discussed here. Therefore, our recommendation is that the reporters be instructed to prepare provisions that subject to higher than usual scrutiny the price paid by a secured party, recourse party, or related party, and other aspects of any foreclosure sale in which those parties buy the collateral. In preparing those provisions, the reporters are not limited to the suggestions made here.

The Subcommittee has described “related parties” as those who are in a common ownership relation with the secured party. Consumer groups have described the “related party” category more broadly to include parties with whom the secured party has regular business dealings. The Subcommittee hesitates to extend the concept beyond common ownership because of the uncertainty created.

The Subcommittee has also used the phrase “reasonable foreclosure value” rather than fair market value or reasonable market value. We have done so in recognition of the fact that in the circumstances of most foreclosure sales, few buyers will pay the same price they would pay in the non-foreclosure situation. Therefore, the relevant value is not “market” value, but “foreclosure” value. . . .⁸⁶

This recommendation, along with several other recommendations of the Benfield Subcommittee, was approved unanimously by the Drafting Committee at its June 6-9, 1996 meeting. The Reporters then requested that Drafting Committee members submit suggested statutory formulations implementing this recommendation. I immediately responded to this request.

Although the recommendation approved by the Drafting Committee in June 1996 was with respect to deficiency claims against consumers, the substance of that recommendation was much the same as the request made to the Reporters in June 1995 which extended to commercial transactions.⁸⁷ The Drafting Committee had again acknowledged that there was a problem which

86. Memorandum from Article 9 Drafting Committee, Consumer Issues Subcommittee to Article 9 Drafting Committee, Advisors, and Observers 7-11 (May 29, 1996) (on file with the *Washington University Law Quarterly*), reprinted in 50 CONSUMER FIN. L.Q. REP. 332 (1996) (slightly reformatted for publication).

87. See *supra* note 84 and accompanying text.

needed to be rectified and that it wanted a special rule for the calculation of deficiency claims where the secured party, or one with whom it had a “relationship,” was the purchaser at the foreclosure sale. Accordingly, the proposal which I submitted made no distinction between commercial and consumer transactions:

Proposed Section 9-50x [9-62x]

(a) Subject to subsection (b), in enforcing a claim to recover a deficiency (Sections 9-502(e)(3), 9-504(d) and 9-505 [9-608(a)(4), 9-614(d) and 9-620]), the deficiency shall be calculated on the basis of (i) any cash proceeds of collection or enforcement received in compliance with Section 9-502, (ii) any acceptance of collateral in partial satisfaction of the obligation made in compliance with Section 9-505, and (iii) the price paid upon any disposition of collateral made in compliance with Section 9-504.

(b) If the purchaser at a disposition of collateral made in compliance with Section 9-504 is the (i) secured party, (ii) an affiliate or insider of the secured party, (iii) a person liable to the secured party under a guaranty, indorsement, repurchase agreement, or the like, or (iv) a person other than those mentioned in (i), (ii) or (iii) but the remaining balance of the obligation is satisfied by a person mentioned in (iii), the calculation of the deficiency shall be made by adjusting the price paid for the collateral to the extent necessary to approximate a fair foreclosure value of the collateral at the time of disposition. “Fair foreclosure value” shall be determined by considering among other things, (1) the actual condition of the collateral, (2) appraisals, evaluations, surveys and the like of the collateral, (3) guidebooks setting forth values of the kind or type of collateral at the time of disposition, (4) estimates of value or ranges of value, if any, made or obtained by the secured party in establishing the minimum acceptable purchase price from a purchaser who is not an affiliate or insider, (5) prices paid at any subsequent dispositions of the collateral by the purchaser, taking into consideration the proximity of the time of such dispositions to the initial disposition and any costs incurred by the purchaser in protecting, marketing, repairing or improving the collateral, (6) prices paid at comparable dispositions of the kind or type of collateral, (7) whether the purchaser is in the business of selling the kind or type of collateral, and (8) market practices and conditions for

dispositions of the kind or type of collateral at the time and place of the disposition of the collateral.⁸⁸

This proposal was based upon my own experiences in private practice handling deficiency actions for numerous secured parties and conversations with business people at CIT who handle Article 9 foreclosure sales and deficiency actions. These people have indicated to me that the proposal essentially reflects their practices and procedures.

It should be noted that this provision for the adjustment of the foreclosure sale price in calculating the amount of the deficiency is mandatory and is not conditioned upon a demand or request by the debtor. Most deficiency actions result in a default judgment against the debtor⁸⁹ and are based upon sworn affidavits of proof made by the secured party, which are filed with the court and set forth the manner in which the deficiency was calculated. Requiring the secured party to spell out the details in a sworn statement with sanctions for false statements should significantly deter the practice of calculating deficiencies on the basis of nominal or disproportionately low bids.

The Reporters did not respond directly to this proposal. Instead, they submitted a memorandum entitled "Alternative Approaches Toward Low-Price Foreclosure Sales to the Secured Party or a Related Party."⁹⁰ This memorandum set forth and briefly discussed five alternative approaches to dealing with the issue. In doing so, the Reporters characterized the problem as one of "self-dealing" and offered several approaches based on the "fiduciary

88. Memorandum from Donald J. Rapson to Prof. Marion Benfield et al. (June 11, 1996) (on file with author) (together with Proposed Section 9-50x revised as of August 8, 1996 to reflect comments from other persons). During the writing of this Article, category (iv) was added to the proposal as a result of a telephone conversation with David M. McMahon of Mountain State Justice, Inc. (W. Va.), the West Virginia Legal Services Plan, discussing this particular factual circumstance and the potential problem. See *supra* note 79; *infra* note 133. The section numbers in brackets refer to the February 1997 Draft of the proposed revision.

89. Creditors often enter default judgments against the debtors without attempting to enforce the judgments at the time of entry. The judgments remain of record for many years and accrue interest. Years later, the judgment defendant may be seeking a loan or other extension of credit from a prospective lender, e.g., a mortgage to buy a home. The judgment defendant may then be required to pay off this "old" judgment, including accrued interest, in order to obtain that loan or credit extension. There is nothing improper about this creditor practice. It does, however point out the need for fair rules in the enforcement of deficiency claims and the need to protect against excessive deficiency judgments.

90. Memorandum from Prof. Steven L. Harris & Charles W. Mooney, Jr., Reporters to Article 9 Drafting Committee (July 30, 1996) (attached hereto in Appendix 1). The Reporters apparently did not feel the need to repeat or restate at length the substance of the various materials presented to, and discussions had by, the Drafting Committee in the previous three and one-half years.

obligation” concept.⁹¹

Although the memorandum did not endorse any of the other alternatives, its Alternative 2, which purported to cover the fair value concept, was given short shrift by the Reporters, reflecting their continued opposition:

Alternative 2: Base deficiency calculation on “value” of collateral in self-dealing dispositions.

For reasons explained in detail at previous meetings, we are not inclined to support Alternative 2 unless, perhaps, all other approaches fail. Valuation, especially the valuation of personal property on foreclosure, is inherently problematic.⁹²

I was greatly disappointed with this memorandum and immediately responded in detail,⁹³ stating that the Reporters in abruptly dismissing Alternative 2 “may be making resolution of the Drafting Committee’s request more difficult than need be”; were “being overly resistant to the [fair value] concept and not recognizing that this is what many secured lenders routinely do in actual practice”; and “use of the phrase ‘self-dealing’ clouds the issue” in suggesting that the “secured party or related parties are somehow acting improperly when they ‘buy-in’ at the foreclosure sale.”⁹⁴ I also stated that “[s]elf-dealing is not the issue—calculation of the deficiency is the problem”; “the Reporters are exaggerating the difficulty of making valuations” and “being conceptually inconsistent” with their own formulation of the rebuttable presumption rule.⁹⁵ Finally, I concluded that the fair value proposal “provides a straightforward resolution of the issue, follows a traditional approach and reflects actual and good business practices.”⁹⁶

Subsequently, the Reporters submitted a new memorandum setting forth a revised set of alternatives, in which they deleted those articulating the fiduciary obligation concept and added three new alternatives, stating:

As things stand, there remains a division among the Drafting Committee and others from whom we have heard. Some favor moving to a value-based rule, others favor the status quo, and others favor

91. *Id.*

92. *Id.* at 2.

93. Memorandum from Donald J. Rapson to Article 9 Drafting Committee (Aug. 8, 1996) (attached hereto in Appendix 2 without its attachments).

94. *Id.* at 1.

95. *Id.* at 1-3.

96. *Id.* at 4.

additional alternatives. We have received no broad support for using a fiduciary standard, although we have received some very strong opposition to that approach. We also received little support for enhanced advertising and notification requirements.

A revised set of alternatives follows. Alternatives 1, 2, and 3 remain unchanged. Alternatives 4 and 5 from our July memorandum have been deleted. We have added three new alternatives (4, 5, and 6). Each of these new alternatives might avoid the need to test self-dealing (and similar) transactions under a special standard.⁹⁷

These new alternatives all involve a determination of value in the calculation of a deficiency:

Alternative 4: Adopt a standard for self-dealing dispositions under which a disposition yielding proceeds less than the reasonably equivalent value would not be in compliance. The reasonably equivalent value, then, would be used to establish the deficiency.

Alternative 4 contemplates the use of “reasonably equivalent value” as interpreted under the Uniform Fraudulent Transfer Act and Bankruptcy Code § 548. In effect, if the disposition would have been avoidable under the (pre-BFP) *Durrett* line of cases, it would not comply with Article 9.

Alternative 5: Provide explicitly in the statute that the “price” received in a disposition is a “term” of a disposition that must be commercially reasonable.

The Drafting Committee has not discussed this approach in some time. When last addressed, the Committee members were divided. This approach would avoid some of the difficulties of requiring a valuation for every deficiency claim while providing that an unreasonably low price cannot be the basis of the deficiency calculation.

97. Memorandum from Profs. Steven L. Harris & Charles W. Mooney, Jr., Reporters to Article 9 Drafting Committee, Advisors, and Observers 1 (Oct. 10, 1996) (attached hereto in Appendix 3 without its attachments).

Alternative 6: Adopt a permissible procedure for calculating a deficiency under which a secured party and debtor could agree to use a standard, published price guide (e.g., automobile “blue book”) to establish the credit toward the secured debt.⁹⁸

The issue again came before the Drafting Committee at its November 1-3, 1996 meeting. At the outset of the meeting, it was announced that certain important consumer creditor organizations, viz., Ford Motor Credit Company, General Motors Acceptance Corporation, Chrysler Financial Corporation, and the American Financial Services Association, were withdrawing from their participation with the Benfield Subcommittee because “nothing in the proposed revision would lead [them] to support the final revisions, and [their] continued participation in the Subcommittee proceedings might be misconstrued as support.”⁹⁹ These consumer creditors expressed concern about the consumer proposals in general, not just those pertaining to deficiency claims:

We have spent a considerable amount of time with the Consumer Credit Subcommittee over the past two years, but in our opinion the consumer proposals do little if anything to improve the system—even for defaulting debtors—while adding considerable dead weight costs that must be borne by our industry or by paying consumers. The current law works very well, and any changes which raise the cost of consumer credit should be supported by a showing that there is demonstrable harm, that the suggested change will remedy that harm, and that the proposed benefits outweigh the costs involved. These principles seem to have been ignored.¹⁰⁰

The Reporters began the discussion of deficiency claims with the suggestion that Alternative 5 afforded the best alternative for getting a consensus for resolution of the issue, i.e., “Provide explicitly in the statute that the ‘price’ received in a disposition is a ‘term’ of a disposition that must be commercially reasonable.”¹⁰¹

Although I preferred the more straightforward fair value concept, I expressed willingness to support that proposal as a compromise because I

98. *Id.* at 2.

99. Letter from Edward J. Heiser, Jr., Esq. of Milwaukee, Wisc. to Prof. Marion W. Benfield, Jr., et al. 2 (Oct. 31, 1996) (on file with the *Washington University Law Quarterly*).

100. *Id.* at 1-2.

101. *See supra* note 97 and accompanying text.

considered it to be sufficiently close to my perception of fair value or fair foreclosure value or reasonable foreclosure value.¹⁰² Discussion of the issue was quite limited. Few details of price as a term of commercial reasonableness were furnished, and none of the other alternatives in the Reporters' Memoranda,¹⁰³ except for fair value (Alternative 2) were mentioned. Some of the Drafting Committee members, however, expressed concern about the uncertainty of the commercially reasonable price concept and its possible ramifications. These members preferred to limit relief to those circumstances where there were "nominal" or "outrageously low" foreclosure sale prices. By a narrow margin, the Drafting Committee indicated a preference for the commercially reasonable price proposal and requested the Reporters to draft proposed statutory language for consideration by the Drafting Committee at its March 7-9, 1997 meeting.

Reflecting on this discussion during the meeting, it became apparent to me that it would not be sufficient for the statutory language to just add price to the concept of commercial reasonableness. If that approach merely treated price as one of several factors in the determination of commercial reasonableness, attention to the importance of the foreclosure sale price or bid in the calculation of a deficiency claim might be diluted. Conversely, that approach might carry with it unnecessary and inappropriate baggage in those circumstances where the price or bid was found to be commercially unreasonable, particularly in consumer transactions, e.g., an absolute bar to any deficiency and harsh statutory damages.¹⁰⁴ If the proposal was to succeed, it was crucial that it be formulated in balanced terms that offer both debtors and secured parties benefits that are not available under present law, without at the same time precluding meaningful relief for the former or causing harsh consequences to the latter.

Consequently, during the course of the meeting, I drafted a compromise proposal, which I discussed briefly with some members of the Drafting

102. See *supra* note 63 and accompanying text.

103. See *supra* notes 90-98 and accompanying text.

104. Under UCC section 9-507(1) such damages are "an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus 10 per cent of the cash price." U.C.C. § 9-507(1) (1995). This can be a very large amount and, in class actions, could be draconian. Draft section 9-624(c) continues that formulation, viz., "an amount equal to the interest or finance charges plus 10 percent of the principal amount of the obligation," except that the statutory damages are reduced by "any amount by which any consumer obligor's personal liability for a deficiency is eliminated or reduced under Section 9-625 [either the absolute bar or rebuttable presumption rule] and any amount for which the secured party is liable under subsection (b) [actual damages]." Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-624(c).

Committee, as well as representatives of the consumer and consumer creditor groups. This proposal, which did not purport to set forth a precise statutory formulation was advanced in the following memorandum¹⁰⁵ which I sent to the Drafting Committee, the Benfield Subcommittee, and other interested persons immediately after the meeting:

Inasmuch as we did not reach a consensus at our weekend meeting, here is a proposal for the resolution of the above issue which I believe offers enough benefits to both consumers and consumer creditors so as to provide a workable compromise. Like any good compromise, it will not make everyone completely happy. But, the alternative of not resolving the issue should be much less acceptable to both groups and to the Drafting Committee.

Although I have shown and discussed most of this proposal with Gail Hillebrand and Ed Heiser, both of whom seem to have some interest, neither has seen this latest version or had an opportunity to discuss it with their colleagues. I expect that both groups will have some reservations. For my part, however, I do not see much room for further compromise. The proposal is very delicately balanced, and I would be concerned that changes may upset that balance. The elements of the compromise are:

1. It uses price or credit as an element of "commercial reasonableness" instead of the "fair value" concept which I have advocated, even though I prefer the latter.

2. This use of "commercially reasonable price or credit" is limited to the calculation of a deficiency or the existence of a surplus. (A secured creditor is given the option to allow a credit that is higher than the foreclosure sale price in calculating a deficiency.) For all other purposes, however, "commercial reasonableness" is only a matter of procedure. Thus, if the secured creditor is not making a deficiency claim or the debtor is not claiming a surplus, the price or credit at the foreclosure sale is completely irrelevant.

3. The proposal avoids the baggage potentially attendant to a general use of "commercially reasonable" price or credit. Thus, if

105. Memorandum from Donald J. Rapson to Article 9 Drafting Committee (Nov. 4, 1996) (on file with the *Washington University Law Quarterly*).

the foreclosure sale is procedurally commercially reasonable, a determination that the price or credit was not commercially reasonable would not result in the application of the “absolute bar” rule or in statutory damages.

4. The proposal covers all deficiency claims, i.e., commercial and consumer, regardless of the identity of the purchaser. However, unless there is a determination that the price or bid used by the secured party in calculating the deficiency is so markedly lower than what a commercially reasonable sale should have realized so as to not be in good faith, the only consequence of the price or bid being commercially unreasonable is that in order for the secured party to recover a deficiency, it must then prove its deficiency claim under the “rebuttable presumption” rule.

5. Recognizing that there must be some deterrence with sanctions against calculating deficiency claims on the basis of prices or bids that are so markedly low as to not be in good faith, the proposal provides for the debtor to recover the reasonable attorney’s fees and expenses incurred in challenging such claims.

6. Consumers may say that the proposal cuts back on consumer rights and remedies in some jurisdictions where by statute or decisional law, price or fair value is already an element of commercial reasonableness. I understand the argument that consumers should not have to give up those protections. By the same token, however, there are many jurisdictions where consumers do not have the rights and remedies afforded by the proposal. In those jurisdictions there is a perception that procedural commercial reasonableness without regard to the price or credit is all that is required. Consumer creditors are understandably loathe to move from that position without some trade-offs, i.e., relief from the absolute bar rule and statutory damages. (If a state adopts the “absolute bar” option being proposed by the Drafting Committee, it would still be applicable to all aspects of commercial unreasonableness other than price or bid.) Because there is some merit on both sides, the proposal takes the position that there should be a “clean slate” going forward in the interests of clarity and in having a uniform rule.

7. Finally, commercial creditors who do not face the “absolute bar” rule or statutory damages, need to be protected against transaction costs resulting from the possibility of increased litigation of deficiency claims. To that end, the proposal makes it clear that a “commercially reasonable” price or a bid is not synonymous with fair market value. Rather, the price or bid need only be within a range of what should have been realized from a commercially reasonable sale. As long as the deficiency claim is calculated on the basis of a price or bid that falls within that range, the claim should be enforced.

In summary, the respective benefits to debtors and secured creditors are as follows:

Benefits to Debtors:

1. Allows challenges to deficiency claims in all cases based on “commercially reasonable price or bid,” notwithstanding procedural commercial reasonableness.
2. Provides incentives to challenging deficiency claims based on markedly low bids that are not in good faith, by permitting debtors to recover reasonable attorney’s fees and expenses incurred in making successful challenges to such claims.
3. Deters deficiency claims that are not based on a commercially reasonable price or bid.

Benefits to Secured Creditors:

1. Eliminates the “absolute bar” rule in cases where there is compliance with procedural commercial reasonableness and the only element of commercial unreasonableness is the price or bid, in which event the “rebuttable presumption” rule is applicable.
2. Eliminates liability for statutory damages where the only element of commercial unreasonableness is the price or bid.
3. Allows the secured creditor, at its option, to calculate a deficiency on the basis of a credit that is higher than the foreclosure sale price in order to facilitate an amicable resolution of its deficiency claim.

PROPOSAL

This section only applies to a sale or disposition of the collateral that is made in compliance with the procedures required by Sections 9-607 through 9-614 and 9-618 to 9-620.

(1) A secured party who seeks to enforce or collect a deficiency claim shall calculate the deficiency on the basis of a commercially reasonable (i) price paid at the sale or disposition or (ii) credit made against the obligation.

(2) A price or bid may be commercially reasonable even though it is less than fair market value. If the price or bid is within a range of the net proceeds that should have been realized from a sale or disposition of the collateral made in compliance with the procedures required under this article, it is commercially reasonable. A secured party complies with subsection (1) if it calculates a deficiency on the basis of such a price, or at its option, on the basis of a credit in a higher amount that is within such range.

(3) If the secured party does not seek to enforce or collect a deficiency claim, the price paid at the sale or disposition or the credit made against the obligation shall not be a factor in determining the existence of commercial reasonableness under Section 9-610, except for purposes of determining whether the debtor is entitled to a surplus.

(4) A secured party who fails to comply with subsection (1) shall then be entitled to enforce or collect the deficiency claim only if it proves that the net proceeds of a commercially reasonable price that would have been paid at the sale or disposition of the collateral is less than the obligation owed by the debtor, and the deficiency shall then be calculated on the basis of that price. If the price or bid used by the secured party in its initial calculation of the deficiency was so markedly lower than the net proceeds that should have been realized from a commercially reasonable sale or disposition of the collateral as to not be in good faith, the secured party shall be liable for reasonable attorney's fees and expenses incurred by the debtor in having the deficiency claim eliminated or reduced. The secured party shall also be subject to the remedies provided under Section

9-624, except that it shall not be liable for statutory damages.¹⁰⁶

The only direct response to the memorandum came from Gail Hillebrand of Consumers Union, one of the consumer representatives.¹⁰⁷ As anticipated, there were some concerns with my proposal and a suggested counter-proposal. The consumer credit organizations for their part opted, instead, to submit "a comprehensive revision to Part 6 of [draft] Article 9 as it deals with consumer credit," which included, *inter alia*, various different proposals for dealing with deficiency actions.¹⁰⁸

On December 13, 1996, the Reporters reviewed the October 1996 Draft Revisions to Article 9 with the Council of The American Law Institute. The subject of deficiency actions was discussed. Later in the day, the Reporters gave an overview of the proposed revisions at an ALI-ABA program on the UCC and indicated that the Council had expressed its support for a revision dealing with this subject, particularly in those circumstances where the purchaser at the foreclosure sale is the secured party or one with whom it has an affiliation or relationship.¹⁰⁹ This was a promising development.

The recent proposals from the consumer representatives and the consumer creditors were sufficiently far apart as to make it unlikely that these two groups would be able to fashion a compromise proposal among themselves. Accordingly, it became incumbent upon the Drafting Committee to develop, on its own, a proposal on deficiency claims, which offers sufficient benefits for each group so as to deter them from rejecting the proposal. I believe that the compromise proposal set forth above¹¹⁰ provided a framework for accomplishing that objective.

D. The Drafting Committee in 1997: Accomplishment

The Reporters focused upon the issue in the February 1997 Draft and offered two approaches. The Prefatory Notes to Part 6 explain:

106. *Id.*

107. Letter from Gail Hillebrand, Consumers Union to Donald J. Rapson, The CIT Group, Inc. (Nov. 26, 1996) (on file with the *Washington University Law Quarterly*).

108. Letter from Edward J. Heiser, Jr., Esq. to William M. Burke (Jan. 15, 1997) with attached Representatives of Consumer Creditors, Proposed Amendments to the October 15, 1996 Draft of Proposed Revisions to Article 9 (Jan. 1997) (on file with the *Washington University Law Quarterly*).

109. Professors Steven L. Harris & Charles W. Mooney, Jr., The Emerged and Emerging New Uniform Commercial Code, Remarks at the Eighth Annual Advanced ALI-ABA Course of Study, New York, New York (Dec. 13, 1996).

110. *See supra* note 105 and accompanying text.

1. Consistent with the Drafting Committee's division of views on the subject, this draft offers two alternative approaches for dealing with dispositions of collateral that are in all respects commercially reasonable as a procedural matter but which produce proceeds of a very low amount.
2. Under either approach, the Drafting Committee must answer one common question: Will the special rules apply in all cases of very low amounts of proceeds or only when, in addition, the purchaser is the secured party, an affiliate of the secured party, or a secondary obligor. If applicable only in the latter set of circumstances, it will be necessary to provide a definition of "affiliate." In this regard, consider the Bankruptcy Code's definition of "affiliate," in 11 U.S.C. § 101(2):
 - (A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
 - (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
 - (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
 - (B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
 - (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

- (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
 - (C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or
 - (D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.
3. One approach is reflected in the bracketed revisions to § 9-610(b). Under these revisions, the amount of proceeds received by a secured party in a disposition would be a term of the disposition that must be commercially reasonable. If the secured party's receipt of a very low amount of proceeds is not commercially reasonable, the provisions dealing with the effect of the secured party's noncompliance with part 6 (primarily, § 9-625) would apply. However, bracketed versions of §§ 9-624 and 9-625 (Alternative A) would make the statutory damages and absolute bar provisions in consumer secured transactions inapplicable when the only noncompliance is a low amount of proceeds.
4. The other approach is reflected in the bracketed revisions to § 9-614, which deals with the calculation of a surplus and a deficiency. Under these revisions, if the secured party receives an unreasonably low amount in a disposition, the surplus and deficiency would not be calculated based on the actual proceeds received but would be recalculated based on an amount of proceeds that is not unreasonably low. This approach would not raise the need for adjustments to §§ 9-624 and 9-625 inasmuch as the low price would not, of itself, constitute noncompliance with the statute.¹¹¹

111. Feb. 1997 Draft, Art. 9, *supra* note 22, pt. 6 rptr.'s prefatory notes.

Both approaches cover commercial and consumer transactions. This was based upon the Drafting Committee's decisions in June 1995 and June 1996.¹¹²

The matter was discussed by the Drafting Committee at its meeting on March 7-9, 1997. First, there was unanimous preference for the approach in section 9-614 which deals solely with the calculation of a surplus and a deficiency, rather than making the foreclosure sale price a term of "commercial reasonableness." Under that approach, "commercial reasonableness" is strictly a matter of procedural compliance, and the reasonableness of the foreclosure sale price or credit is treated separately in the context where it is most relevant—deficiency claims. Thus, if there is a determination that the foreclosure sales price or bid was "unreasonably low," the only consequence is a readjustment of the deficiency. If the sale procedurally is otherwise "commercially reasonable," there would be no application of an absolute bar rule or imposition of statutory damages. This is consistent with the compromise proposal I advanced in November 1996.¹¹³

The Drafting Committee then discussed the question posed by the Reporters in the Prefatory Note: "Will the special rules apply in all cases of very low amount of proceeds or only when, in addition, the purchaser is the secured party, an affiliate of the secured party, or a secondary obligor?" Although I preferred that the rule cover all deficiency claims, the majority of the Drafting Committee voted to limit coverage to the latter group—i.e., the circumstances where the problem is most acute. The effect of this decision was to approve Alternative A to proposed section 9-614(e) which provides:

(e) If the amount of proceeds received by the secured party in a disposition is unreasonably low and the purchaser in the disposition is the secured party, an affiliate of the secured party, or a secondary obligor, the surplus or deficiency under subsection (d) is calculated based on the proceeds that would have been realized in a commercially reasonable disposition to a purchaser other than the secured party, an affiliate of the secured party, or a secondary obligor.¹¹⁴

I am gratified with this result. More, however, remains to be done. The rule requires a fact-sensitive determination of the amount of proceeds that

112. See *supra* notes 82-87 and accompanying text.

113. See *supra* notes 105-06 and accompanying text.

114. Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-614(e) alt.A.

“would have been realized in a commercially reasonable disposition to a purchaser other than the secured party, an affiliate of the secured party, or a secondary obligor.”¹¹⁵ Comments will have to be written which provide meaningful guidance to the fact-finder by setting forth the various factors which should be considered in making that determination. The substance of these Comments will be important and, perhaps controversial. I am confident, nevertheless, that this can be done. In my view, the eight categories of factors described in subsection (b) of my earlier proposal should be the starting basis of the Comments.¹¹⁶

The next step in the process will take place in May 1997 when the latest draft of Article 9 will be briefly considered by The American Law Institute at its Annual Meeting in Washington, D.C. and in July 1997 when there will be a first reading of the entire draft before the Annual Meeting of NCCUSL in Sacramento, California. The decisions of the Drafting Committee deserve support, and I am optimistic about the eventual result.

III. CONCLUSION

There should be no disagreement with the proposition that a secured party “is not entitled to recover more than the full amount” of the debt. That is the premise of the fair value rule,¹¹⁷ which is the established majority rule in real property security law¹¹⁸ and was applied to personal property security law in some states prior to the adoption of UCC Article 9,¹¹⁹ and is presently applied in some states.¹²⁰

In imposing a duty of commercial reasonableness upon secured parties in the enforcement of their rights upon default under Article 9, Grant Gilmore, the principal architect of Article 9, viewed that duty as the conceptual equivalent of a fiduciary obligation—“[t]he obligation of the secured party is to use his best efforts to see that the highest price is received for the collateral.”¹²¹ Gilmore viewed the Code procedures of public sale, notification, and publicity “[a]s the best way to produce a fair price.”¹²² The

115. *Id.*

116. *See supra* note 88 and accompanying text.

117. *See supra* note 60 and accompanying text.

118. RESTATEMENT OF MORTGAGES, *supra* note 14, § 8.4.

119. *See sources cited supra* note 15.

120. *See sources cited supra* note 16.

121. 2 GILMORE, *supra* note 2, § 44.5, at 1232-34; *supra* note 41.

122. *Id.* § 44.6, at 1245.

concept of fair value is completely consistent with that objective.¹²³

Somehow that message has been lost in the interpretation and application of commercial reasonableness. Gilmore himself stumbled in applying that standard to the “really serious problem” of the common circumstance where, despite compliance with the procedures of commercial reasonableness, no bidders appear and the secured party bids in the collateral¹²⁴—Case #2.¹²⁵ As a matter of basic justice, logic, and intellectual consistency, the fair value rule should be applicable in both commercial and consumer transactions whenever the secured party seeks to enforce a deficiency claim because the established real estate rule and the duty of commercial reasonableness were both designed to achieve the same goal of realizing fair value.¹²⁶

Fair value does not necessarily mean fair market value. The application of that standard should not result in the imposition of unrealistic, unfair, or burdensome duties upon secured parties. Fair value is not a fixed amount—rather it should be viewed as a range of values, and, as long as the debtor receives a credit against his or her obligation that falls within that range in the calculation of a deficiency, the secured party has complied with its obligations. If recharacterization of fair value as fair foreclosure value or reasonable foreclosure value will contribute to a better understanding of that concept, let it be done.¹²⁷ The goal is to prevent deficiency claims from being calculated on the basis of foreclosure sale prices or bids that are unreasonably low.¹²⁸

I would prefer that the forthcoming revision of Article 9 make something akin to the fair value concept applicable to all deficiency claims. The rule adopted by the Drafting Committee only covers cases where the proceeds of the sale or disposition are “unreasonably low”¹²⁹ and is limited to the circumstance where the secured party, a related party, or a recourse party bids in and becomes the purchaser at the foreclosure sale, e.g., Case #2.¹³⁰ Certainly, that is the “really serious problem”¹³¹ and the circumstance most susceptible to abusive and improper deficiency claims. The Drafting

123. See *supra* notes 40-41 and accompanying text.

124. 2 GILMORE, *supra* note 2, § 44.6, at 1243, 1245.

125. See *supra* note 22 and accompanying text.

126. 2 GILMORE, *supra* note 2, § 44.5, at 1233-34.

127. See *supra* notes 61-63 and accompanying text.

128. See *supra* note 105 and accompanying text.

129. See *supra* note 114 and accompanying text.

130. See *supra* note 22 and accompanying text.

131. 2 GILMORE, *supra* note 2, § 44.5, at 1243.

Committee's rule governs those instances where the purchaser is the (i) secured party; (ii) an affiliate or insider of the secured party; or (iii) a person liable to the secured party under a guaranty, indorsement, repurchase agreement, or the like "i.e. secondary obligor."¹³² Inasmuch as those categories appear to generally exclude all instances where the purchaser is an independent third party, broader application of the rule may not be needed.¹³³ Indeed, the proposed statute expressly requires that there be a determination of what "would have been realized in a commercially reasonable disposition to a purchaser *other than*"¹³⁴ someone in the three enumerated categories. It should be an acceptable compromise.

Although it is probably unrealistic to expect that the Drafting Committee's decision will be supported by all representatives of secured creditors or all representatives of consumer and other debtor groups, I believe that there will be general support for the proposed rule. It is a moderate, balanced and meaningful approach to a difficult and controversial issue. From the perspective of debtors, it focuses on those circumstances where the problem is most acute. I expect that most consumer groups will support an enactment of this proposed rule even though it does not go as far as they would have preferred. Secured creditors, for their part, should approach the matter objectively and not quarrel with a rule that requires them to defend their calculation of deficiency claims in those circumstances where, because of the potential lack of genuine competitive bidding, the foreclosure sale price or bid may not reasonably reflect the value of the collateral. Moreover, even though the proposed rule may expose secured creditors to additional challenges of deficiency claims in those instances, the corollary abolition of the absolute bar rule and liability for statutory damages are meaningful off-setting benefits for consumer creditors. In my view, creditor groups would be short sighted and ill-advised to oppose enactment of this rule or the overall revision of Article 9.¹³⁵

132. *See supra* note 22 and accompanying text.

133. If, however, the secured party can then recover the balance of the obligation from a secondary obligor, there may not be sufficient incentive to realize a higher price at the foreclosure sale. That is the reason for the addition of category (iv) to the proposal. *See supra* note 88.

134. Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-614(e) alt.A (emphasis added).

135. For example, at the March 7-9, 1997 meeting of the Drafting Committee, approval was given to the addition of two consumer creditor protection provisions based on section 130 of the Federal Truth-in-Lending Act: (i) a good faith error defense relieving the creditor from statutory damages for failure to comply with the provisions of Article 9 governing default where the error "was not intentional and resulted from a good-faith error notwithstanding the secured party's maintenance of procedures reasonably adapted to avoid the failure" and (ii) a limitation of recoveries in class actions

I hope that this article will contribute to a better understanding of the issue and develop wide-spread support for the rule being proposed by the Article 9 Drafting Committee. It represents an important improvement and clarification of present law. Gilmore would have repented and agreed.

to the lesser of \$500,000 or one per centum of the net worth of the creditor (not yet drafted). See 15 U.S.C. § 1630(a)(2)(B), (C) (1994); Feb. 1997 Draft, Art. 9, *supra* note 22, § 9-627(d).

APPENDIX 1

MEMORANDUM TO: Article 9 Drafting Committee
FROM: Stephen L. Harris and Charles W. Mooney, Jr.,
Reporters
DATE: July 30, 1996
RE: Alternative approaches toward low-price
foreclosure sales to the secured party or a
related party

On several occasions a few people have suggested that the calculation of a deficiency should be based on the value of collateral instead of the net proceeds of a disposition. They expressed concern that even a commercially reasonable disposition (i.e., one that is procedurally correct with respect to advertising and the like) may produce a very small price that is substantially less than the value of the collateral.

The Drafting Committee consistently has decided to retain net proceeds as the basis for calculating a deficiency when a disposition is commercially reasonable, as under current law. At its June meeting, however, the Drafting Committee renewed its request that we consider and suggest alternatives for dealing with “self-dealing” transactions in which the purchaser is the secured party, a person closely related or connected to the secured party, or a recourse party. (We had suspended any efforts to address this problem until the consumer transactions sub-committee completed its work.) The thought is that addressing the self-dealing situations may effectively address the great majority of the low-price dispositions as well.

The purpose of this memo is to solicit your preliminary views on some alternative approaches, with a view toward incorporating one or more of them into the draft to be considered at the November meeting of the Drafting Committee. For present purposes, we shall assume that devising an acceptable definition of “related party,” “affiliate,” or similar term is possible. (We would, of course, be happy to receive your suggestions for the definition.)

Please review the alternatives and let one of us know your reactions to them no later than the end of August. In particular, we would like to

know which of the alternatives you believe to be the most promising approach and which you find the least promising.

[*2¹] Alternatives 3, 4A, 4B, and 5 are inspired in part by Luize Zubrow's article in 42 UCLA L. Rev. 445 (1994). For the June, 1995, Drafting Committee meeting in Washington, we distributed Professor Zubrow's synopsis of her article. There was little interest in pursuing her recommendations at that time. However, they now seem particularly relevant to the Drafting Committee's current interest in pursuing some special provisions for self-dealing dispositions.

We welcome your comments.

Alternative 1: When the amount of a deficiency is in issue following a self-dealing disposition, require the secured party to prove with "clear and convincing evidence" that it complied with the requirements of Part 5.

Alternative 1 would retain the "commercially reasonable" standard applicable under current law but would impose upon the secured party a higher burden of proving that its conduct complied with the standard (i.e., proving compliance by clear and convincing evidence rather than by evidence showing that it is more probable than not that the secured party complied).

Alternative 2: Base deficiency calculation on "value" of collateral in self-dealing dispositions.

For reasons explained in detail at previous meetings, we are not inclined to support Alternative 2 unless, perhaps, all other approaches fail. Valuation, especially the valuation of personal property on foreclosure, is inherently problematic.

Alternative 3: Adopt a procedural standard for self-dealing dispositions that is more demanding than "commercially reasonable." Examples include: "reasonably designed to obtain the best possible price," "reasonably designed to obtain the fair value," and "reasonably designed to obtain the greatest net proceeds."

Alternative 3 would require all aspects of a self-dealing disposition to be designed to realize the fair value, best possible price, or a similar standard.

1. [Editor's Note: Star paging reflects the pagination in the original memorandum.]

Unlike Alternative 2, under Alternative 3 evidence that the actual disposition price is less than the property's value (however defined) would not be determinative, although it would be probative. Arguably, however, courts might find it convenient to apply Alternative 3 much like Alternative 2 would be applied.

[*3] Alternative 4A: Provide that in a self-dealing disposition a secured party is a fiduciary that owes a duty of loyalty to the debtor.

Alternative 4B: Adopt Alternative 3 and, in addition, provide that in a self-dealing disposition a secured party is a fiduciary that owes a duty of loyalty to the debtor.

Alternatives 4A and 4B would invite courts to apply standards of non-UCC law applicable to fiduciaries in self-dealing transactions.

Alternative 5: Adopt Alternative 3, 4A, or 4B and, in addition, provide a safe harbor for the secured party if it makes full disclosure to the debtor concerning the disposition, undertakes more extensive advertising, and the debtor approves of the terms of the disposition in advance.

Alternative 5 would permit a secured party to calculate a deficiency or surplus based upon the actual net proceeds received, as under current law. To base the calculations on actual net proceeds, however, the secured party would be required to disclose to the debtor all material facts concerning the disposition, undertake more extensive advertising than under current law (such as including an opening bid for a public sale), and obtain the debtor's approval before the disposition.

S.L.H.

C.W.M.

APPENDIX 2

MEMORANDUM TO: Article 9 Drafting Committee
FROM: Donald J. Rapson
DATE: August 8, 1996
RE: **Alternative approaches toward low-price
foreclosure sales to the secured party or a related
party**

This is in response to the Reporters' memorandum dated July 30, 1996 requesting responses to various alternative approaches set forth therein.

I respectfully suggest that the Reporters may be making resolution of the Drafting Committee's request more difficult than need be. More particularly, in giving short shrift to Alternative 2 (Base deficiency calculation on "value" of collateral in self-dealing dispositions) because valuation is "inherently problematic", the Reporters are being overly resistant to the concept and not recognizing that this is what many secured lenders routinely do in actual practice and what many courts do in personal property deficiency actions, e.g. New Jersey and New York

Initially, it should be noted that the Drafting Committee agreed at its June 1995 meeting "by a wide margin to ask the Reporters to explore language affecting the calculation of deficiencies when the secured party buys the collateral". See Steve Weise's ABA report of that meeting. The Drafting Committee's approval of the Benfield Consumer Subcommittee recommendation at the June 1996 meeting was an affirmation of that earlier decision.

I would also note that the use of the phrase "self-dealing" clouds the issue in that it suggests that secured or related parties are somehow acting improperly when they "buy in" at the foreclosure sale. This often happens even though the foreclosure procedure, in terms of notice, advertising and the like, is "commercially reasonable" in all respects. The reality is that foreclosure sales, no matter how impeccably conducted, frequently do not result in sufficient competitive bidding by third parties and the secured party has no choice but to "bid in" in the collateral. The "bid" price, however, often has no relation to the value of the collateral and there is no reason or incentive for it to reflect that value. "Self-dealing" is not the issue--

calculation of the deficiency is the problem.

Immediately following the June 1996 Drafting Committee meeting, I supplied the Reporters and Marion Benfield with a draft proposal for calculation of the deficiency that would require an adjustment of the foreclosure sale price “to the extent necessary to approximate a ‘fair foreclosure value’ of the collateral at the time of disposition”. The proposal sets forth various factors which should be considered in determining “fair foreclosure value”. The Comment would explain that the objective is to determine a value that falls within a range that is reasonable under the circumstances after consideration of these various factors. For example, the Comment would [*2¹] explain that a foreclosure sale by a financing institution which is not in the business of selling the particular kind of collateral should generally be expected to realize proceeds in the range of the wholesale, as distinguished from, retail value.

At the Reporters’ suggestion, I previously sent the proposal to Gail Hillebrand and Ed Heiser. The proposal, however, was not referred to in the Reporters’ memorandum.

This proposal is based on my personal experiences in handling several hundred deficiency actions for secured lenders (real and personal property) during the years I was in private practice and numerous conversations with several businesspeople at CIT who handle personal property foreclosure sales and deficiency actions. I have been told that the draft reflects their actual practices. A copy of the proposal, modified to reflect some suggestions, is attached.

Let me reiterate, however, that the “fair value” concept in deficiency actions set forth in this proposal (which does not necessarily mean “fair market value”) is neither new nor particularly controversial. It is the established majority rule in real property deficiency actions, it was the legislative rule in some states prior to Article 9, it is the judicial rule in Article 9 deficiency actions in some states, e.g. New Jersey and New York, and is likely to continue to be the rule in those states even if the Drafting Committee were to recommend a less protective rule. In my view, all the other alternatives advanced by the Reporters are significantly more “problematic”

1. [Editor’s Note: Star paging reflects the pagination of the original memorandum.]

than Alternative 2.

I believe that the Reporters are exaggerating the difficulty of making valuations. Secured lenders do that as part of their regular procedure in conducting foreclosure sales. Courts and other forums regularly determine valuation issues and even though the process of dealing with conflicting expert testimony is sometimes difficult, it is no more so than determining what is “commercially reasonable”. My differences with the Reporters on this point mirror those expressed in the 5-4 Supreme Court decision in BFT v. RTC, 128 L. Ed.2d 556 (1994), involving the related, but different, issue of the conclusiveness of a foreclosure sale price for fraudulent transfer purposes. Justice Souter, who had prior experience as a litigator and state court judge, in speaking for the dissent cogently rejected the majority’s fear of having judicial determinations of value:

I do not share in my colleagues’ apparently extreme discomfort at the prospect of vesting bankruptcy courts with responsibility for determining whether “reasonably equivalent value” was received in cases like this one, nor is the suggestion well taken that doing so is an improper abdication. Those courts regularly make comparably difficult (and contestable) determinations about the “reasonably equivalent value” of assets transferred through other means than foreclosure sales, see e.g. Covey v. Commercial Nat. Bank, 960 [*3] F.2d 657, 661-662 [26 C.B.C.2d 1046] (CA7 1992) (rejecting creditor’s claim that resale price may be presumed to be “reasonably equivalent value” when that creditor seiz[es] an asset and sell[s] it for just enough to cover its loan (even if it would have been worth substantially more as part of an ongoing enterprise)); In re Morris Communications N.C., Inc., 914 F.2d 458 [23 C.B.C.2d 1456] (CA4 1990) (for “reasonably equivalent value” purposes, worth of entry in cellular phone license “lottery” should be discounted to reflect probability of winning); cf. In re Royal Coach Country, Inc., 125 B.R. 668, 673-674 (Bkrtcy. Ct. MD Fla. 1991) (avoiding exchange of 1984 truck valued at \$2,800 for 1981 car valued at \$500), and there is every reason to believe that they, familiar with these cases (and with local conditions) as we are not, will give the term sensible content in evaluating particular transfers on foreclosure,***”. 128 L. Ed.2d. at 578-9.

Moreover, it strikes me that the Reporters are being conceptually inconsistent. The rebuttable presumption rule in draft § 9-504(c)(2)(ii)(B) on page 242-3 requires a determination of “the amount of proceeds that would

have been realized had the noncomplying secured party proceeded in accordance with Section 9-502, 9-504, or 9-505". That determination of "amount" is, as a practical matter, essentially the same as the determination of "fair foreclosure value" because it involves the same proof factors. Today, when the secured party is found to have not satisfied the "commercial reasonableness" requirement and has the burden of overcoming the rebuttable presumption rule in order to enforce a deficiency, it offers evidence as to the fair value of the collateral which the debtor then challenges. Why is that any less "problematic"?

Finally, it should be remembered that the Benfield Subcommittee, in making its recommendation, referred to the recent ALI approval of Section 8.4 of the Restatement of Mortgages, which gives the debtor a right to request a fair market value determination in all deficiency actions following a real estate mortgage foreclosure. That rule follows the legislative or judicial rule in a majority of the states. (A copy of the ALI proposal is attached). Although the argument can be made that the "commercial reasonableness" requirement in Article 9 somehow adds a protective factor that is not in most real estate foreclosure rules, I believe that the argument is more theoretical than real. As a practical matter there is little difference between a procedurally correct (i.e. duly noticed and advertised) real estate mortgage foreclosure sale conducted by and held in the Sheriff's office and a procedurally correct Article 9 foreclosure sale conducted by the secured party held on the courthouse steps, a dealer's or empty lot, or in the office of the secured party or its attorney. If the secured party bids in because the bidding, if any, does not reach the "upset" or "let-go" price established by the secured party, that bid does not necessarily reflect the value of the collateral and should be subject to adjustment if the secured party brings a deficiency claim. The "fair foreclosure value" concept being advanced here is much narrower than the Restatement rule and is limited to the circumstance where the secured party [*4] or a related or recourse party is the purchaser. This proposal provides a straightforward resolution of the issue, follows a traditional approach and reflects actual and good business practices.

/s/
DJR/es

Attachments

APPENDIX 3

MEMORANDUM TO: Article 9 Drafting Committee, Advisors, and Observers

FROM: Steven L. Harris and Charles W. Mooney, Jr., Reporters

DATE: October 10, 1996

RE: Alternative approaches toward low-price foreclosure sales to the secured party or a related party

Last summer we distributed a memorandum dated July 30, 1996, which outlined several alternative approaches for dealing with low-price foreclosure sales to the secured party or a related party. A copy of the memorandum is enclosed. Also enclosed are a letter and memorandum from David McMahon, which we received after preparing our memorandum, along with several written responses to our memorandum. We received several other less formal responses, which are not enclosed, some of which took strong objection to a value-based calculation of a deficiency.

As things stand, there remains a division among the Drafting Committee and others from whom we have heard. Some favor moving to a value-based rule, others favor the status quo, and others favor additional alternatives. We have received no broad support for using a fiduciary standard, although we have received some very strong opposition to that approach. We also received little support for enhanced advertising and notification requirements.

A revised set of alternatives follows. Alternatives 1, 2, and 3 remain unchanged. Alternatives 4 and 5 from our July memorandum have been deleted. We have added three new alternatives (4, 5, and 6). Each of these new alternatives might avoid the need to test self-dealing (and similar) transactions under a special standard.

Alternative 1: When the amount of a deficiency is in issue following a self-dealing disposition, require the secured party to prove with "clear and convincing evidence" that it complied with the requirements of Part 5.

Alternative 2: Base the deficiency calculation on the "value" of

collateral in self-dealing dispositions.

Alternative 3: Adopt a procedural standard for self-dealing dispositions that is more demanding than “commercially reasonable.” Examples include: “reasonably designed to obtain the [*2¹] best possible price,” “reasonably designed to obtain the fair value,” and “reasonably designed to obtain the greatest possible net proceeds.”

Alternative 4: Adopt a standard for self-dealing dispositions under which a disposition yielding proceeds less than the reasonably equivalent value would not be in compliance. The reasonably equivalent value, then, would be used to establish the deficiency.

Alternative 4 contemplates the use of “reasonably equivalent value” as interpreted under the Uniform Fraudulent Transfer Act and Bankruptcy Code § 548. In effect, if the disposition would have been avoidable under the (pre-*BFP*) *Durrett* line of cases, it would not comply with Article 9.

Alternative 5: Provide explicitly in the statute that the “price” received in a disposition is a “term” of a disposition that must be commercially reasonable.

The Drafting Committee has not discussed this approach in some time. When last addressed, the Committee members were divided. This approach would avoid some of the difficulties of requiring a valuation for every deficiency claim while providing that an unreasonably low price cannot be the basis of the deficiency calculation.

Alternative 6: Adopt a permissible procedure for calculating a deficiency under which a secured party and debtor could agree to use a standard, published price guide (e.g., automobile “blue book”) to establish the credit toward the secured debt.

This proposal is explained in David McMahon’s enclosed letter and memorandum. (We realize that it has not been proposed as an alternative to the other proposals but could be adopted in addition to another alternative.)

We hope that the foregoing and the enclosures will be useful in the effort to reach a consensus.

1. [Editor’s Note: Star paging reflects the pagination of the original memorandum.]