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# Enforcement of Article 9 Security Interests—Why So Much Deference to the Junior Secured Party

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# ENFORCEMENT OF ARTICLE 9 SECURITY INTERESTS—WHY SO MUCH DEFERENCE TO THE JUNIOR SECURED PARTY?

*C. Edward Dobbs\**

## I. INTRODUCTION

This Essay addresses the question whether the Uniform Commercial Code (UCC or the Code) is dead or alive in the context of certain remedies provisions set forth in Part 5 of Article 9. The Essay concludes that while far from dead, the patient is sick and in need of some treatment. Unlike other areas of the Code in need of some resuscitation born of changes in the manner in which commercial transactions are conducted, the illness found in certain provisions of Part 5 was present at the creation. That the provisions have survived so long without cure is more a testament to the ready adaptation of the commercial world to flaws in the statute than to the absence of a need for reform.

In its Final Report dated December 1, 1992 (PEB Final Report), the Article 9 Study Committee of the Permanent Editorial Board for the Uniform Commercial Code (PEB Study Committee) made numerous suggestions for revisions of certain provisions or official comments to Part 5 of Article 9.<sup>1</sup> This Essay does not attempt to address the bulk of those recommendations.<sup>2</sup> Rather, this Essay focuses upon those provisions of Part 5 that deal with the relative rights and duties

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

2. Some of the more significant recommendations include the following: (1) expanding the class of parties entitled to notice of collateral dispositions; (2) eliminating the requirement of possession in connection with a strict foreclosure; (3) authorizing a strict foreclosure in partial satisfaction of the indebtedness; (4) permitting certain obligors who have no interest in the collateral to give predefault waivers of certain rights or certain duties of the secured party with respect to the collateral; (5) providing a "safe harbor" rule for notices of collateral dispositions; (6) clarifying the categories of Part 5 rights and remedies that may be altered by agreement of the parties; (7) eliminating the so-called absolute bar rule in favor of the so-called rebuttable presumption rule applicable to commercially unreasonable dispositions of collateral; and (8) expanding the pool of aggrieved parties who may claim damages under § 9-507. See *id.* at 199-247.

of junior and senior secured parties in connection with the foreclosure process. This Essay concludes that those provisions are unjustifiably tilted in favor of the junior secured party and should be revised, in several instances along the lines suggested by the PEB Study Committee.

## II. COMMERCIAL REALITIES AND LEGITIMATE EXPECTATIONS

A secured party whose willingness to extend credit is based upon the value of collateral to secure the credit extension should, and usually will, take steps to perfect its security interest and to confirm by record search the priority that its interest will enjoy. If the search reveals a prior encumbrance upon the collateral, then the secured party faces a choice: decline to extend the requested credit, condition the credit extension upon the release or subordination of the prior encumbrance, or proceed with the credit transaction notwithstanding the prior encumbrance.

A secured party who extends credit with knowledge of a prior security interest, and notwithstanding its existence, may be described as an "advertent junior secured party." An advertent junior should be distinguished from an "inadvertent junior" who intended to obtain a senior security interest but failed to do so—whether as a result of misfiling, lapse of filing, or otherwise. A third category of junior is one whose credit decision is unmotivated by the priority of the security interest it receives and who accepts the proffered collateral position without inquiry into its value—that is, "for whatever it's worth."

Whether advertent, inadvertent, or indifferent, the junior understands that its priority will not be elevated until the senior claim is paid in full. The senior's foreclosure will extinguish the junior's security interest and the junior will not be entitled to notice of the senior's foreclosure—or to any surplus resulting therefrom—unless the junior gives timely notice of its interest in the collateral as required by section 9-504(3).<sup>3</sup>

In the commercial world, the goals of the advertent and indifferent junior are the same—to position themselves with respect to the collateral ahead of any secured parties whose interests are later in time and ahead of all unsecured creditors. It is not their expectation to leapfrog over the senior's position through a preemptive, first-

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3. See U.C.C. § 9-504(3) (1990).

strike foreclosure.<sup>4</sup> The inadvertent junior, whose goal from the inception of the credit extension was to attain a senior position, must, unfortunately, conform its expectations to the reality of its situation. Another goal of the junior is to obtain leverage over the debtor. If a default occurs, the junior's interest in the collateral empowers it to use the threat of foreclosure to force action on the part of the debtor.

These goals of the junior generally can coexist peacefully with the primary, bargained-for goal of the senior, which is to have the paramount right to conduct and receive the proceeds from any disposition of the collateral. Many provisions in Part 5 of Article 9 literally confer rights upon the junior that are at odds with the normal commercial expectations of the parties, thereby creating unnecessary conflict between the junior and the senior. On occasion intercreditor agreements resolve these conflicts between the senior and junior, with the contractual resolution typically varying the Article 9 rules that might otherwise favor the junior. Absent a contractual resolution, some courts construe the relevant provisions of Part 5 in a manner that is inconsistent with their plain meaning in order to achieve a result that is more consistent with commercial realities and expectations. Secured parties by intercreditor agreement, and some courts by artificial construction, attempt to circumvent the Code's plain meaning regarding a junior's enforcement rights. The Code should therefore be amended to conform to commercial practice.

### III. COLLECTION RIGHTS OF THE JUNIOR

Section 9-502(1) of the Code entitles a secured party, after default, to notify an account debtor or an obligor on an instrument to make payment to the secured party. Section 9-318(3) adds teeth to the secured party's collection remedy. This section requires the account debtor to pay the notifying secured party, instead of the debtor, when the account debtor receives notice of the debtor's assignment of the right to payment.<sup>5</sup>

But what if an account is subject to multiple security interests? May a junior secured party exercise collection rights and, if so, retain

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4. There is some question whether an advertent or indifferent junior whose security interest is obtained in knowing violation of a negative-pledge clause in a senior's security interest should have any recourse to the collateral.

5. U.C.C. § 9-318(3) (1990). Indeed, the account debtor's failure to pay the secured party may result in the account debtor's having to pay again. *See, e.g., Valley Nat'l Bank v. Flagstaff Dairy*, 570 P.2d 200 (Ariz. Ct. App. 1977).

the proceeds in derogation of the senior's interests?<sup>6</sup> If the account debtor receives conflicting payment directives from several assignees of the account, to whom is payment to be made? Article 9 does not adequately resolve these questions.

By not expressly prohibiting a junior from exercising collection rights, the Code inferentially allows the junior to do so. Unlike a junior's disposition of tangible collateral, where the senior at least retains its interest in the collateral, the collection of an account or an instrument extinguishes the underlying collateral to the extent of payment.<sup>7</sup> Absent a rule entitling the senior to receive the junior's collection proceeds, the senior's priority interest in the collateral is rendered valueless.<sup>8</sup>

The senior's ability to follow the junior's collection notice with a notice of its own does not obviate the senior's concerns over the junior's initiation of collection. First, Article 9 does not clearly identify who the account debtor must pay in the event of its receipt of conflicting notifications. The account debtor cannot be expected to resolve priority contests; it may elect to honor the first collection notice it receives—or neither of them. Second, the right to exercise the section 9-502 collection remedy is not conditioned upon giving prior notice to either the debtor or other secured parties. Accordingly, there is no assurance that the senior would have forewarning of the junior's exercise of such a remedy. Finally, the experience of many financial institutions that are expert in dealing with accounts collateral is that account debtors who are confronted with conflicting demands for payment usually refuse to pay anyone. In such circumstances the secured parties may have to bear the otherwise avoidable cost and delays of litigation.

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6. *PEB Commentary No. 7*, [PEB Commentaries] U.C.C. Rep. Serv. (Callaghan) (Mar. 10, 1990), states that a party who holds a junior security interest in an account and receives the account debtor's check in payment of the account, whether directly from the account debtor or by way of negotiation from the debtor, may retain the check as against the claim of a party holding a senior interest in the account if the junior is a holder in due course of the account. *See* U.C.C. § 9-309. This PEB Commentary addresses a different question than the one discussed in the text, which looks to the entitlement of the junior to exercise § 9-502 collection rights in the first instance and thereafter to retain the collection proceeds.

7. The junior might also elect to compromise the amount of the debtor's claim against the account debtor, which presumably would bind not only the debtor but also the senior secured party, whose existence was unknown to the account debtor.

8. Although there is a dearth of case law, the prevailing view appears to be that the junior must account for and turn over to the senior any proceeds that the junior collects under § 9-502. *See, e.g.,* *New Hampshire Business Dev. Corp. v. F.R. Lepage Bakery, Inc.*, 832 F.2d 7 (1st Cir. 1987); *Delaware Truck Sales, Inc. v. Wilson*, 618 A.2d 303 (N.J. 1993).

Commercial lenders and factors typically seek to avoid the risks posed by a junior interest in accounts collateral in one of two ways: (1) by exacting the debtor's agreement to refrain from granting further encumbrances upon the collateral; or (2) by conditioning their consent to a subordinate security interest in the accounts upon the junior's agreement to forebear from exercising collection rights altogether until the senior's claim is paid in full.<sup>9</sup> Given that commercial institutions routinely address these problems by agreement, Article 9 might be revised to embody the customary expectations of the parties and thereby dispense with the necessity for such agreements.

The PEB Study Committee suggests augmenting the official comments to explain that a junior may receive and retain collections from an account debtor if the junior acts in "good faith" and "without knowledge that the collections violate the rights of a [s]enior."<sup>10</sup> The committee's proposed good faith and knowledge test, however, addresses only the circumstances under which the junior is authorized to retain collections. The test does not address the junior's right to initiate collection efforts in the first place. Further, unless the junior is charged with knowledge of senior interests perfected of record, the junior may be unaware of the existence of a senior and consequently fail to give notice to the senior of the junior's initiation of collection.

Article 9 should be amended to provide that, absent a contrary agreement among the parties, a junior may not invoke the section 9-502 collection remedy unless it has first given reasonable notification of its intention to exercise such a remedy. Such notification must be given to each senior who holds an interest of record in the account<sup>11</sup> or who is otherwise known to have a senior interest in the account or an instrument. If the senior fails to exercise its collection remedy with respect to the collateral prior to the expiration of the notice period, the junior would be authorized to proceed with collection efforts. However, the junior would be bound to account for all collections and to turn them over to the senior net of the junior's reasonable collection expenses. If at any time the senior elects to initiate collection, the junior would be required to discontinue its collection efforts with respect to any account debtor to whom the junior had not theretofore

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9. Alternatively, the intercreditor agreement may sanction the junior's assertion of collection rights. However, the sanction applies only if the senior fails to assert such rights for a period of time after receiving notice of the junior's intent to exercise § 9-502 rights, and then only if the net proceeds of the junior's collection are turned over to the senior.

10. STUDY GROUP REPORT, *supra* note 1, at 222.

11. Notice should be required without regard to whether or not the senior gave written notice to the junior of the senior's interest in the collateral.

sent a section 9-502 collection notice.<sup>12</sup> The account debtor should be exonerated from any liability if, faced with conflicting claims to payment, it acts in good faith and remits payment to any secured party to whom payment would otherwise have been proper if a notification had been received only from that party.

The foregoing proposals satisfy a number of legitimate concerns of the parties involved in a collection context. The proposals preserve the junior's leverage over the debtor by permitting the junior to initiate collection, but only after giving reasonable notice to the senior and subject to the senior not proceeding with its own collection efforts. While the junior must turn over all collections to the senior, it is allowed to deduct reasonable expenses. The likelihood of an account debtor being confronted with conflicting collection notices is reduced. And in the event of such conflicting notices, the account debtor is protected if it acts in good faith and pays any of the parties who would have been entitled to payment in the absence of conflicting notices.

#### IV. JUNIOR'S RIGHT TO FORECLOSE

Article 9 does not reserve to a senior secured party the exclusive right to foreclose upon collateral that is subject to subordinate security interests. The clear indication from the language of Article 9, and the consensus of authority,<sup>13</sup> is that a junior has the right to dispose of the collateral after default despite the presence of senior interests. A contrary rule would strip the junior of its bargained-for leverage over the debtor, subject the junior's enforcement rights to the potential whim of prior interest holders, and, ironically, place the junior in a potentially less advantageous position than an unsecured creditor who obtains a judgment against the debtor.<sup>14</sup>

To acknowledge the propriety of a rule that permits the junior to foreclose, however, is not to say that the senior interest holders are undeserving of certain additional protections that should inure to them by virtue of their senior status. One fundamental protection is the senior's right to notice. As currently written, Article 9 limits the class of secured parties entitled to notice to those parties from whom the foreclosing secured party has received written notice of a claim of

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12. This proposal is consistent with the PEB Study Committee's recommendation that a junior who has repossessed collateral be required to turn over the collateral to the senior who requests it and has a right to possession as against the debtor. STUDY GROUP REPORT, *supra* note 1, at 220.

13. See cases cited *infra* note 27.

14. See U.C.C. § 9-301(4) (1990).

an interest in the collateral.<sup>15</sup> When a junior proposes to dispose of collateral after default, the junior should be obliged to give notice to all senior secured parties whose interests are of record in the state or are otherwise known to the junior.<sup>16</sup> The senior's receipt of notice would enable it to take appropriate steps to monitor the junior's foreclosure or, as hereinafter discussed, to interdict it.

If a junior is the first to repossess collateral and to notice a foreclosure sale, a senior has no express right under Article 9 to require the junior to turn the collateral over to the senior for disposition under Part 5 of Article 9.<sup>17</sup> The PEB Study Committee recommends revisions to Article 9 or the official comments to clarify "that a [s]enior is entitled to recover possession of the collateral from a [j]unior if the [s]enior has the right to possession as against the debtor."<sup>18</sup> An interdiction of the junior's foreclosure, however, should be permitted only when the senior intends to follow through with its own disposition of collateral and not to reinstate the possession of the debtor.

The PEB Study Committee's recommendation is appropriate and strikes a fair balance between the rights of the junior and senior secured parties. The party having the senior interest in the collateral can gain control of the collateral from the junior and superintend the disposition of its collateral; the junior will receive any surplus after satisfaction of the senior's claim. If the senior's claim is small in relation to the value of the collateral or the amount of the junior claim, the junior may elect to redeem the collateral<sup>19</sup> or purchase it at a public sale by the senior. The senior, meanwhile, is constrained in the manner of its disposition by the commercial reasonableness requirements of Article 9. The junior may sue the senior under section 9-507(1) if the senior fails to conduct a commercially reasonable sale.

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15. *Id.* § 9-504(3).

16. The effect of this rule would be to resurrect the pre-1972 text of § 9-504(3) insofar as notices to senior secured parties are concerned. It is not suggested that the same rule apply to notices by the subordinate to secured parties junior to it or notices by the senior to any other secured party. In those circumstances the current rule works well. It is little burden upon a junior to send to each senior, whose identity can be ascertained at the time the junior obtains its interest, a notice of the junior's interest in the collateral. It is a far greater—and unnecessary—burden on a senior to update periodically its UCC searches to determine whether the debtor has further encumbered the collateral.

17. At least one case has recognized such a requirement on the part of the junior. *E.g.*, *American Heritage Bank & Trust Co. v. O. & E., Inc.*, 576 P.2d 566 (Colo. Ct. App. 1978).

18. STUDY GROUP REPORT, *supra* note 1, at 220-22. Of course, there may be circumstances in which the senior is unable to freely exercise its remedies, such as when the senior has been temporarily enjoined or is otherwise embroiled in litigation with the debtor.

19. U.C.C. § 9-506.



Finally, the junior's ability to enforce its interest after default, and thereby precipitate a chain of events that will lead to ultimate realization upon the collateral, preserves the junior's leverage against the debtor.

#### V. JUNIOR'S RIGHT TO RECEIVE AND RETAIN FORECLOSURE PROCEEDS

Section 9-504(1) establishes how to apply proceeds realized from the disposition of collateral. Section 9-504(1)(a) directs that such proceeds are to be first applied to the reasonable repossession and foreclosure expenses and—to the extent authorized by the security agreement and not prohibited by law—legal expenses incurred by the secured party. The balance<sup>20</sup> is to be applied first to the satisfaction of the secured party's claim and then to the claim of any junior from whom the foreclosing secured party has received, before final distribution of the proceeds, a "written notification of demand therefor."<sup>21</sup>

If the secured party conducting the collateral disposition is the holder of the senior interest, then, with one exception, the application rules of section 9-504(1) work well. The exception is the requirement that the proceeds remaining after payment of the senior's claim be remitted to the holder of a subordinate security interest. Literally read, this requirement directs the senior to skip over a statutory or common-law lienor whose lien, though inferior to the senior's, is superior under applicable law to the subordinate security interest. Because the senior's foreclosure discharges that lien,<sup>22</sup> it would be palpably unfair to pass over the lienor in favor of a subordinate security interest with respect to the surplus proceeds.<sup>23</sup> While such a result was likely not intended, the imprecise language employed in section 9-

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20. The likelihood of a surplus will depend not only upon the realizable value of the collateral in relation to that claim but also upon the nature of the collateral. When the collateral is a single, indivisible item such as an automobile, airplane, or printing press, the secured party has little choice other than to dispose of the entirety of the collateral and, if a surplus results, the surplus application rules of § 9-504(1) will be relevant. On the other hand, when the collateral consists of inventory or accounts, the secured party usually will foreclose upon only so much of the collateral as is necessary to satisfy its claim and thereupon relinquish possession of any remaining collateral.

21. U.C.C. § 9-504(1) (1990).

22. See U.C.C. § 9-504(4), which states that the secured party's disposition of collateral "discharges" its security interest and "any security interest or lien subordinate thereto."

23. See BARKLEY CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 4.06[3], at 4-99 (rev. ed. 1993) ("It is unfortunate that [§ 9-504(1)(c)] gives junior judgment creditors no protection."). The PEB Study Committee has recommended that the distribution rules of § 9-504(1) be revised to entitle the holder of a subordinate non-UCC lien to receive a distribution of excess proceeds as long as the

504(1) could subject the foreclosing secured party to potential liability for failure to follow the letter of the law.

If, however, the junior forecloses upon the collateral, the question arises whether the junior is entitled under Article 9 to apply the net proceeds to its claim in preference to the claim of the senior. If so, should such a rule be changed? The language of section 9-504(1) offers little comfort to a senior secured party. That section, far from suggesting that the senior has first call on the disposition proceeds, plainly states that the foreclosing secured party—without differentiating between senior and junior—takes first, then the subordinate security interest holders, and finally the debtor.<sup>24</sup> Under this reading of Article 9, surplus disposition proceeds must always be passed down, and never up, the priority ladder.<sup>25</sup>

Although this reading has the support of some respected commentators,<sup>26</sup> the courts have not uniformly agreed with such a result.<sup>27</sup>

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holder of the subordinate lien has given the senior timely written notice of a demand for distribution. See STUDY GROUP REPORT, *supra* note 1, at 215.

24. An Article 9 junior secured party would appear to fare better under the Code in this regard than a party holding an inferior non-Code lien. For example, in many states a judgment lienor must turn over to a senior secured party the proceeds received from a judicial sale. See, e.g., *United States v. Monroe Serv. Co.*, 901 F.2d 610 (7th Cir. 1990).

25. See, e.g., *First Union Nat'l Bank v. Tectamar, Inc.*, 235 S.E.2d 894 (N.C. Ct. App. 1977) (finding junior's payment of foreclosure proceeds to senior improper).

An interesting, but unanswered, question under Article 9 is whether § 9-504(1) requires a secured party to turn over the first proceeds from a collateral disposition to the holder of a lien—for example, a judgment lien—that has priority under applicable non-UCC law. As discussed in the text, § 9-504(1) speaks only in terms of sharing proceeds with junior secured parties and the debtor. Assume, for the sake of argument, that non-UCC applicable law requires the foreclosing secured party to satisfy prior statutory liens from the foreclosure proceeds. If the statutory lien was superior to the foreclosing secured party's interest but subordinate to the senior's interests, then Article 9 and non-UCC law would oblige the junior to pass the realization proceeds upstream only to the extent necessary to satisfy a lien inferior to the senior's interest. This would be an anomalous result at best.

26. See 2 JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 27-9, at 592-94 (3d ed. 1988 & Supp. 1994). But see Cynthia Starnes, *U.C.C. Section 9-504 Sales by Junior Secured Parties: Is a Senior Party Entitled to Notice and Proceeds?*, 52 U. PITT. L. REV. 563 (1991).

27. For cases requiring the junior to remit the foreclosure proceeds to the senior, see *Harley-Davidson Motor Co. v. Bank of New England—Old Colony, N.A.*, 897 F.2d 611 (1st Cir. 1990); *New Hampshire Business Dev. Corp. v. F.R. Lepage Bakery, Inc.*, 832 F.2d 7 (1st Cir. 1987); *In re Whatley*, 126 B.R. 231 (Bankr. N.D. Miss. 1991); *Stotts v. Johnson*, 791 S.W.2d 351 (Ark. 1990); *Consolidated Equip. Sales, Inc. v. First State Bank & Trust Co.*, 627 P.2d 432 (Okla. 1981); *Rushmore State Bank v. Kurylas, Inc.*, 424 N.W.2d 649 (S.D. 1988).

For cases ruling that the junior has first rights to the disposition proceeds when the junior conducts the sale, see *United States v. Cohoon*, 11 U.C.C. Rep. Serv. 2d (Callaghan) 316 (E.D.N.C. 1990); *Continental Bank, N.A. v. Krebs*, 540 N.E.2d 1023 (Ill. App. Ct.

The rationale offered for a policy excluding the senior's right to share in the junior's disposition proceeds is that the senior may always enforce its security interest in the collateral acquired by the purchaser at foreclosure because the senior's interest is not discharged. But the senior may not always be able to locate either the purchaser or the collateral, particularly if the senior does not receive prior notice of the foreclosure sale.<sup>28</sup> Article 9 must be revised to require the junior to give a disposition notice to the senior whether or not the senior has previously notified the junior of the senior's security interest. If Article 9 is not so revised, the senior may not be alerted to the foreclosure and thus may be unprepared to protect its interest. Furthermore, in the case of a private sale of the collateral, notice from the junior of the time after which the collateral may be sold will not necessarily inform the senior of the actual date of the sale or the identity of the ultimate purchaser. Such information may not even be known to the junior at the time the notice of private sale is given. Apart from the issue of notice, when the junior conducts a public sale of multiple items of collateral in separate lots, it may be impractical or unduly expensive for the secured party to retrieve the collateral from each purchaser.<sup>29</sup> In any event what is the point of priority if the senior's rights and expectations can be so easily defeated?

As for the good faith purchaser at foreclosure, what protection does it have against subsequent loss of the collateral to the senior? It has been suggested that the purchaser will take into account the existence of the senior's interest in determining the purchase price to be paid to the junior.<sup>30</sup> This suggestion assumes that the purchaser will be aware of the senior's position, an assumption that may often be

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1989); *Chadron Energy Corp. v. First Nat'l Bank*, 459 N.W.2d 718 (Neb. 1990); *First Union Nat'l Bank*, 235 S.E.2d at 894.

28. At least one court has ruled that the foreclosing secured party has no duty to disclose the identity of the buyer of the collateral to a senior lienor who has not given notice of its interest in the collateral and that the foreclosing secured party does not act in bad faith by refusing to reveal the buyer's name. *Utility Trailers, Inc. v. Citizens Nat'l Bank & Trust Co.*, 726 P.2d 282 (Kan. Ct. App. 1986). The senior's right to follow the collateral into the hands of the foreclosure purchaser is of little benefit if the senior does not receive notice of the sale and if, after learning of the sale, the senior has no means of compelling disclosure of the purchaser's identity.

29. If the senior appeared at the junior's public auction threatening to repossess on the spot each item sold, the senior could effectively scuttle the sale. What is the logic of a system that would permit a junior to foreclose and retain the foreclosure proceeds as against a senior, who, having possibly no other means of protection, is forced to frustrate the sale or defeat the interests of the purchasers?

30. STUDY GROUP REPORT, *supra* note 1, at 219.

incorrect.<sup>31</sup> Even if the existence of a senior lien is known to a prospective purchaser, the purchaser may not have adequate information about the amount of the senior's claim to calculate a net purchase price. The suggestion also assumes that the senior's claim is less than the value of the collateral to be sold. If the collateral exceeded the value of the senior's claim, an informed purchaser presumably would not conclude the purchase unless it did not expect the senior to demand the purchased collateral.

More to the point, however, a knowing purchaser will likely take into account the risk associated with an undischarged senior lien and adjust the purchase price accordingly. Consequently, why not simply put the burden upon the junior to collect the amount of the adjustment and remit it to the senior in satisfaction of the senior claim? One may question whether a sale of an item of collateral for less than its acknowledged value, to reflect the purchaser's taking subject to the senior's interest, is a commercially reasonable sale. The senior is certainly not obligated to pursue the collateral into the hands of the purchaser. If the senior elects not to do so, the purchaser receives a windfall, the debtor remains liable to the senior for that portion of the senior's claim that was not satisfied due to the adjustment in the purchase price, and subordinate lienholders on remaining items of collateral subject to the senior's liens are harmed.

## VI. EFFECT ON JUNIOR OF SENIOR'S STRICT FORECLOSURE

Section 9-505(2) of the Code permits a secured party to conduct a so-called strict foreclosure by proposing, in writing, to retain the collateral in satisfaction of the debt. The foreclosing secured party must send the proposal to the debtor and any other secured party from whom the foreclosing secured party has received a timely written no-

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31. Of course the purchaser may conduct a record search to ascertain the existence of such liens. In practice, however, such searches are infrequently conducted except in negotiated private sales.

The PEB Study Committee recommends that Article 9 or the official comments be revised to state explicitly that absent a disclaimer or modification, the foreclosing secured party will be deemed to have made warranties of title in a foreclosure sale. *Id.* at 218-19. In determining whether to disclaim or limit such a warranty, the prudent secured party would undertake a record search to verify the existence of any superior security interest or liens. If so, the secured party presumably would disclose them to the purchaser, who in turn would take those liens into account in calculating the price the purchaser is willing to pay at foreclosure. If this suggestion is adopted, it would not increase the burden upon the foreclosing secured party to provide a disposition notice to those identified as holders of senior interests in the collateral, regardless of whether such seniors have notified the foreclosing secured party of their security interests in the collateral.

tice of a claim of an interest in the collateral. If a person entitled to receive the secured party's strict foreclosure proposal gives notice of an objection to the proposal within twenty-one days, the foreclosing secured party must dispose of the collateral by public or private sale under section 9-504; otherwise, the secured party becomes the owner of the collateral and the secured debt is deemed satisfied.

Strict foreclosure may be an attractive remedy when the amount of the secured party's claim exceeds any reasonable valuation that may be placed upon the collateral, the secured party does not have other collateral or a solvent obligor from which to recover a deficiency, and the secured party desires to effect a speedy and economical disposition. However, the potential usefulness of the strict foreclosure option is sorely limited under section 9-505 as currently written. Unlike section 9-504, a strict foreclosure under section 9-505 does not expressly discharge junior security interests and liens on the collateral. While some support exists for the proposition that a strict foreclosure does extinguish junior encumbrances,<sup>32</sup> there is sufficient room for doubt. Thus, reliance upon the strict foreclosure remedy is a risky venture when junior encumbrances exist.

The PEB Study Committee has suggested a revision to Article 9 to clarify that a strict foreclosure extinguishes all junior encumbrances—both junior security interests and non-UCC liens—on the collateral.<sup>33</sup> Such a revision would enhance the utility of strict foreclosure and should be adopted.

#### VII. JUNIOR'S WAIVER OF SENIOR'S DUTY OF COMMERCIAL REASONABLENESS

Under section 9-507(1), if a secured party disposes of collateral in a commercially unreasonable manner, "any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition" has a right to recover from the secured party any loss caused by a failure to comply with the provisions of Part 5.<sup>34</sup>

Frequently, two creditors in a commercial transaction will extend loans or other financial accommodations to a debtor at the same time. One creditor is the senior secured lender and the other, the junior, provides funding that is contractually subordinated only to the senior.

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32. See *Food City, Inc. v. Fleming Cos.*, 590 S.W.2d 754 (Tex. Ct. App. 1979); 2 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 44.3, at 1225-26 (1965).

33. STUDY GROUP REPORT, *supra* note 1, at 244-45.

34. U.C.C. § 9-507(1) (1990).

The junior often requests a second lien, behind the senior, with respect to the same assets of the debtor that the senior's security interest encumbers. The senior may very well balk at the notion of consenting to a junior encumbrance upon the collateral,<sup>35</sup> for by doing so, the senior may assume unwanted duties and potential liabilities to the junior with respect to the senior's handling of a disposition of collateral.

Hence, an informed senior usually conditions consent for the grant of a junior encumbrance upon the junior's execution of an intercreditor agreement that addresses a number of issues. In addition to establishing the priorities of the parties' respective interests in the collateral, the intercreditor agreement likely will call upon the junior to stand by from any enforcement of its lien until the senior's claim is paid in full and to turn over any proceeds of collateral that may come into the junior's possession. Further, the senior may insist that the subordinate lender agree in advance to release its lien in connection with the debtor's postdefault liquidation of the collateral for the senior's benefit. This agreement prevents the junior from holding the collateral hostage in such a situation.

The senior may potentially assume liability to a junior for failure to comply with Part 5. Thus, the senior will be more inclined to consent to a junior interest if the subordinate lender can effectively waive the senior's duty to the junior to dispose of collateral in a commercially reasonable manner. The indifferent junior can be expected to give such a waiver freely. The advertent junior must again make a credit decision, but often will be willing to waive the senior's commercial reasonableness duties on the belief that any disposition of the collateral is more likely to occur in the context of the debtor's bankruptcy than by the senior's enforcement of its security interest.<sup>36</sup>

It is not altogether clear, however, whether the subordinate lender may effectively waive the senior's obligation to conduct a commercially reasonable disposition of the collateral. Section 9-501(3) establishes various rights of the debtor and duties of the secured party that may not be waived or varied by agreement between the two. One of the duties of a secured party that may not be waived or varied is

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35. The senior's consent is generally necessary because the senior's security agreement prohibits the debtor from granting other security interests in the collateral.

36. Such a waiver might also enhance the marketability of the collateral in a foreclosure sale. Under § 9-504(4) a purchaser at public foreclosure takes free of junior liens only if the purchaser has no knowledge of any defects in the sale. A purchaser presumably would have less concern with a potential noncompliance insofar as a junior lienholder is concerned if the junior had waived its rights to challenge the commercial reasonableness of the disposition.

liability under section 9-507 for failure to comply with Part 5. Such liability extends to a secured party's failure to conduct a commercially reasonable disposition of the collateral. Section 9-501(3) does not, by its terms, prohibit two secured parties—a senior and a junior—from agreeing to waive rights that they might otherwise have against one another by virtue of their noncompliance with Part 5.<sup>37</sup>

Section 1-102(3), however, broadly invalidates purported contractual disclaimers of the obligations of good faith, diligence, reasonableness, and care imposed by the Code. That section has been invoked to nullify debtors' written disclaimers of the commercial reasonableness requirement<sup>38</sup> and would appear to apply with equal force to disclaimers by junior secured parties.

In light of the uncertainty, Article 9 should be revised to clarify that secured parties may make such agreements and give such waivers as they deem appropriate as between themselves and subject to the usual contract doctrines relating to good faith, unconscionability, duress, and adhesion contracts.<sup>39</sup> Such a revision would facilitate the willingness of senior secured parties to consent to junior encumbrances and would eliminate the current uncertainty about the effectiveness of such waivers. There appear to be no valid reasons for Article 9 to inhibit freedom of contract between secured parties.

### VIII. CONCLUSION

Part 5 of Article 9, by literal reading or clear implication, purports to confer enforcement rights upon junior secured parties that exceed their legitimate commercial expectations and may defeat the bargained-for rights of seniors. Practice demonstrates that juniors are usually unhesitant in waiving many of those rights and that seniors routinely insist upon such waivers in exchange for their consent to the debtor's grant of a junior interest in the collateral.

When the junior interest is created without the knowledge of the senior, and possibly in violation of the senior's security agreement, the senior is unable to exact the customary waivers from the junior in an

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37. Instead, § 9-501(3) prohibits a waiver or variance only of those terms that "give rights to the debtor *and* impose duties on the secured party." U.C.C. § 9-501(3) (emphasis added). The conjunction allows one to interpret the section to proscribe only a waiver or variance of the secured party's duty of commercial reasonableness vis-a-vis the debtor.

38. See, e.g., *May v. Women's Bank, N.A.*, 807 P.2d 1145 (Colo. 1991) (en banc).

39. There is authority for the proposition that a commercial guarantor should be able to give predefault waivers of defenses that might arise from a commercially unreasonable sale. See *Chrysler Credit Corp. v. H & H Chrysler-Plymouth-Dodge, Inc.*, 927 F.2d 270 (6th Cir. 1991).

intercreditor agreement. In such circumstances many courts have declined to permit juniors to realize all of the benefits that Part 5 of Article 9 confers upon them. In so doing, those courts have ignored what some commentators believe to be the plain meaning of the Article 9 provisions in question.

Revision is needed to clarify the enforcement rights of juniors and to conform the extent of those rights to commercial practice and the legitimate expectations of the parties.



