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Secured Transactions

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SECURED TRANSACTIONS

DEBTOR'S RIGHT TO NOTICE UPON DISPOSITION OF COLLATERAL

In *Norton v. National Bank of Commerce*,[1] the Arkansas Supreme Court attempted to assess the relative rights and duties of three parties engaged in two secured transactions. Since the validity of the court's reasoning is open to some doubt, and since section 1-102(1)(c) of the Code might lead other courts to follow this case for the sake of uniformity, the opinion deserves serious attention.

The defendant in this litigation was a dealer in used automobiles who sold a 1957 Oldsmobile to one Goldsmith. Goldsmith, who was not a party to this action, executed a promissory note and a conditional sales contract for the purchase price. The dealer negotiated the note and assigned the contract to the plaintiff bank under a written contract of assignment. Under the terms of the contract, which the bank had drafted and used regularly in this kind of financing, the transaction took the form of a sale of the chattel paper. It was provided, however, that upon demand by the bank, the dealer would repurchase the chattel paper for the amount remaining due thereon.[2] It was also provided that the dealer "waived" all demands and notices to which he might otherwise have been entitled, and that the bank's remedy of compelling repurchase was not exclusive, but cumulative.[3]

Notwithstanding this last clause, it was the bank's customary practice to exercise its remedy of repurchase before taking any other action.[4] When Goldsmith defaulted, however, the bank made no such demand and, without giving notice to either Goldsmith or the dealer, it repossessed the car and resold it at a private sale. The purchaser, one of the bank's customers, paid $75.00, leaving a deficiency of $277.88. Upon the dealer's refusal to pay the deficiency, the bank sued him for the amount still due on the note, claiming that he was obligated to pay because of the repurchase agreement. The trial court entered judgment for the bank, and the dealer appealed on the ground that, under section 9-504(3) of the Code, the bank should have given him notice of the proposed disposition, and that the bank's failure to do so had discharged his entire liability.

In considering the dealer's claim that he should have been notified, the Arkansas Supreme Court referred to section 9-504(3)[5] which provides that "unless collateral . . . is of a type customarily sold on a recognized market . . . reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor . . . ." The only issue to be decided, then, was whether the dealer was a "debtor" as to the collateral disposed of, that is, the automobile.

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[1] 398 S.W.2d 538 (Ark. 1966).

[2] Id. at 539.

[3] Brief of Joe C. Barrett, Esq. as Amicus Curiae, p. 2, quoting language from the contract.

[4] 398 S.W.2d at 539.

[5] Id. at 540.

As a preliminary matter, the court rejected the bank's contention that a used car falls within the exception for goods "customarily sold on a recognized market."[6] Then the court proceeded to the central issue by focusing upon the Code's definition of "debtor" as set forth in section 9-105(d): "Debtor means the person who owes payment or other performance of the obligation secured . . . and includes the seller of . . . chattel paper." In construing this language, the court, in effect, held that, as the seller of chattel paper who had promised to repurchase it, the dealer owed "other performance" of Goldsmith's obligation. Having thus been characterized as a debtor, the dealer was held to have been entitled to notice under section 9-504(3).[7]

Tangentially, the court also dismissed the bank's contention that the dealer had waived his right to notice, holding that, under section 9-501(3), the attempted waiver was ineffective.[8] The court did not, however, accept the dealer's claim that the bank's failure to notify him had discharged his *entire* liability. The court noted that section 9-507(1) provides only that if a secured party has disposed of the collateral in a manner not in accordance with the Code, "any person entitled to notification . . . has a right to recover from the secured party any loss caused by a failure to comply with the provisions of the Code."[9] It is clear that what is recoverable under this section is the actual provable loss which is by no means the entire liability in every case. The court went beyond this provision, however, and stated that the bank's wrongful disposition of the collateral had made it difficult, if not impossible, for the dealer to prove the extent of his loss with reasonable certainty. Therefore, the court would assume that the value of the collateral had been equivalent to the amount of the debt, thus shifting to the bank the burden of proving the extent of the dealer's loss.[10]

The opinion in the instant case raises three issues which must be examined in some detail. First, it is necessary to consider whether sections 9-105(d) and 9-504(3) will support the court's conclusion that the dealer was a debtor entitled to notice. Second, if the dealer is not such a debtor, it will be necessary to determine the character of the relationship between the dealer and the bank. Finally, no matter what the relationship, there is a question as to what, if any, liability the bank has incurred in disposing of the collateral in this manner.

In evaluating the court's conclusion that the dealer was a debtor entitled to notice, the essential consideration is that there were *two* secured transactions. The first was between Goldsmith and the dealer to secure the purchase of the automobile, and the second was between the dealer and the bank to secure the dealer's promise to repurchase. It is submitted that under

[6] Ibid.

[7] Id. at 540-41.

[8] Id. at 541.

[9] Id. at 541-42.

[10] The court explicitly rejected the positions set forth in the two amicus briefs it had requested. The briefs were filed by Harry E. Meek, Esq. and Joe C. Barrett, Esq., both of the Arkansas Bar. Mr. Barrett was assisted by Professor Soia Mentschikoff, Professor Robert Braucher, and Walter D. Malcolm, Esq., members of the Permanent Editorial Board of the Uniform Commercial Code. These briefs were extremely valuable in the preparation of this comment.

section 9-504(3), the debtor in the second secured transaction is not necessarily entitled to notice upon disposition of the collateral of the first. Rather, as that section indicates, to be entitled to notice of the disposition of collateral, one must be a debtor in the sense that he owes payment or other performance of the obligation secured by that collateral. It is not enough to be a debtor on a separate, though related, transaction. To concede that the dealer is a debtor as the seller of the chattel paper is only to raise the material question whether he was a debtor as to the automobile—whether he owed payment or other performance of Goldsmith's obligation. Before considering this question, however, it is particularly important to establish exactly what the parties had, in fact, agreed to do.

In construing the agreement between the bank and the dealer, one part of the Code which must be kept in mind is section 1-205(3), which provides that "a course of dealing between parties and any usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware give particular meaning to and supplement or qualify terms of an agreement." In this locale, it was the standard practice of the commercial financing business, and the customary procedure of this bank as well, to offer the chattel paper to the assignor before any disposition of the buyer's collateral.[11] Further, the dealer in the instant case had always fulfilled his obligation to repurchase upon request,[12] and this was the first time that the bank had deviated from this standard business practice. It seems clear, then, that this practice of offering the chattel paper for repurchase *before* disposition of the car had become part of the "usage of trade"[13] and "course of dealing"[14] between the parties. In view of this fact, it is submitted that the result contemplated by the parties was not that the dealer would be a debtor, but that he would resume the status of secured party. That this was their expectation can be demonstrated most clearly by examining the implications of the standard methods of loan financing and then examining the relationships in the instant case.

Consider first the simplest type of loan financing in which a dealer sells an automobile on credit for $1,000. Assume that the buyer is obligated to make payments to the dealer on the first of each month for twelve months, and that the dealer subsequently pledges this obligation to a bank as security for a short-term, single-payment loan of $500 due six months later. Clearly, the dealer's obligation to repay *his* loan would be a duty assumed as a part of his transaction with the bank. There is no difficulty in distinguishing the two transactions and it is obvious that, as pledgor of the chattel paper, the dealer is a debtor as to his own obligation which is secured by the chattel paper, *not* by the automobile.

Second, consider another loan transaction with somewhat different terms. Assume the same contract between the buyer and the dealer for the conditional sale of the automobile. If, however, the dealer borrowed $1,000, instead of $500, and contracted to repay the bank in twelve install-

[11] 398 S.W.2d at 539.

[12] Ibid.

[13] U.C.C. § 1-205(2). All citations to the Code are to the 1962 Official Text.

[14] U.C.C. § 1-205(1).

ments, payable on the first of each month, the following would occur. On the first of each month, the buyer would pay the dealer and the dealer would pay the bank. Obviously, since the terms of this transaction between the dealer and the bank are so similar to those between the buyer and the dealer, it would be more convenient to eliminate this intermediate step by having the buyer pay the bank directly. If such an arrangement were made, however, it would be simply a matter of form and, if the buyer defaulted, he would be defaulting on his debt to the dealer, who would continue to pay the bank, not as a surety on the buyer's obligation, but as principal obligor on his own.

In both forms of loan financing presented above, the dealer is not a debtor on the buyer's obligation, but, as to the buyer, he is a secured party. In the instant case, the dealer did not pledge the chattel paper, but he *assigned* it to the bank together with a promise to repurchase it on the buyer's default for an amount equivalent to that still owed by the buyer.[15] In this situation, the buyer pays the bank, not as a result of commercial convenience, but because the bank has assumed the dealer's position as creditor. It is critical to note, however, that, in the end, this arrangement is designed to have the same practical effect as loan financing. In this case, as well as in the straight loan transaction, the dealer's obligation runs to the bank, and his recourse is against the buyer's collateral. In the straight loan transaction, the dealer is always the secured party vis-à-vis the buyer, and, in the instant case, he has contracted to *resume* the status of secured party by repurchasing the chattel paper. The dealer did not owe "other performance" of Goldsmith's obligation, and he was thus not a debtor as to the automobile. He was not, therefore, entitled to notice upon its disposition.

Of course, the fact that the bank had no duty to give notice does not mean that the bank had no duty at all. It is necessary to examine further the terms of this security agreement, as qualified by section 1-205, to determine what other duties the bank might have owed to the dealer. In addition, it is also necessary to consider how the dealer's duty to repurchase was affected by the bank's disposition of the automobile. As shown above, the bank should have given the dealer an opportunity to repurchase the chattel paper before it disposed of the automobile. By its express terms, the security agreement obligated the dealer to repurchase on demand, but by virtue of section 1-205, it also obligated the bank to offer the chattel paper *before* any disposition of the automobile.[16] Clearly the bank had a right to compel repurchase of the chattel paper, but if it sought to hold the dealer *fully* liable, it also had a duty to offer the paper before disposing of the automobile. Thus, the bank may have damaged the dealer, *not* by failing to notify him of the proposed sale, but by deviating from its "course of dealing" in not giving him an opportunity to repurchase the chattel paper before disposition. This breach of the bank's obligation would not, however, cause a discharge of the dealer's obligation. Under this agreement, the dealer's duty to repurchase continued even

[15] 398 S.W.2d at 539.

[16] See Provident Tradesmens Bank & Trust Co. v. Pemberton, 24 Pa. D. & C.2d 720, aff'd, 196 Pa. Super. 180, 173 A.2d 780, (1961).

after the disposition of the automobile, for it does not appear that the contract made his duty contingent upon the preservation of the automobile as collateral. Certainly, neither the court nor the litigants have indicated that this was their view of the transaction, and, therefore, in the instant case, the dealer would be able to counterclaim for the damages arising from the bank's failure to offer the chattel paper before disposition of the automobile.[17] This, however, raises the separate issue of how these damages should be ascertained.

Under the court's analysis, or under the position taken in this comment, the court is correct in holding that the bank's improper disposition would not cause a discharge of the dealer's liability. There is a real question, however, as to whether section 9-507 is applicable, and, if so, there is further doubt as to the court's shifting of the burden of proof. If the court were correct in holding that the dealer was a debtor entitled to notice under section 9-504(3), then section 9-507 would apply; but that section allows only the recovery of actual damages and does not provide for any discharge. In the few decisions which have treated this issue, the courts have generally held that no discharge should be imposed, and that recovery should be limited to actual damages.[18]

It does not seem, however, that the dealer would be entitled to recover under section 9-507, for this section indicates that recovery from the secured party is limited to "loss caused by failure to comply with the provisions of this Part," that is, Part 5 of Article 9. The dealer's right to repurchase the chattel paper before disposition was a right guaranteed by the implicit terms of this particular security agreement; it was not a right under Part 5 of Article 9, such as the right to notification given by section 9-504(3). Therefore, the bank's failure to give the dealer an opportunity to repurchase was a breach of their contract rather than a violation of a Code requirement. Strictly speaking, then, section 9-507 does not control the question of the dealer's damages, and, assuming no contrary statutory provision, this question could be decided on a non-Code breach of contract theory. If the court had held that the dealer was not a debtor, but that the rights and liabilities of these parties arose from their contract, and, if the dealer's damages are in fact so difficult to ascertain, then perhaps the court's theory of shifting the burden of proof would be a more equitable solution. If, however, the court was applying section 9-507, this shift of the burden of proof was clearly not called for by the statutory language. Under the Code, it is generally the complaining party, here the dealer, who has the duty of showing not only the violation of the Code, but also the extent of the resulting loss.[19]

The end result of this litigation may well turn out to be correct in terms

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[17] This is analogous to the loan arrangement. If the bank had improperly discounted the dealer's chattel paper to a third party, the dealer would not be discharged from his obligation to the bank, but he could recover any damages caused by the bank's improper disposition.

[18] E.g., Alliance Discount Corp. v. Shaw, 195 Pa. Super. 601, 171 A.2d 548 (1961); Atlas Credit Corp. v. Dolbow, 193 Pa. Super. 649, 165 A.2d 704 (1960). Contra, Associates Discount Corp. v. Cary, 47 Misc. 2d 369, 262 N.Y.S.2d 646 (N.Y. City Civ. Ct. 1965).

[19] Coogan, Hogan & Vagts, Secured Transactions under the Uniform Commercial Code § 8.06 (1966).

of apportioning the financial loss. If it does, however, it will be the result of good fortune rather than a proper interpretation of the Code. The dealer was not a debtor entitled to notice of disposition of the automobile, but he was damaged by the bank's failure to offer the chattel paper before disposition. He was thus entitled to recover actual damages, but he was not entitled to a discharge of his liability. The court's treatment of the damages question does violence to section 9-507(1), but perhaps an accurate damages award will be made anyway. Despite the Code's mandate for uniformity,[20] it seems clear that this case should not be followed by the next court to consider the problem.

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[20] U.C.C. § 1-102(1)(c).