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To Improve or Not to Improve? Pre-Disposition Preparation and Processing of Collateral

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This article examines whether a secured party who seeks to dispose of collateral after default has an obligation to improve the collateral prior to disposition. Section 9-610(a) of the Uniform Commercial Code (UCC) states that a secured party after default may dispose of collateral "in its present condition or following any commercially reasonable preparation or processing." This provision suggests that a secured creditor has the option on default to dispose of collateral as is, without any cleaning, painting, or other preparation or processing. Despite the plain language of section 9-610(a) of the UCC, the official comments to section 9-610 and the prevailing case law on post-default collateral disposition tell a different story. After default, a secured party might, in fact, have a duty to fix up collateral before selling, leasing, licensing, or otherwise disposing of it.

Commercial Reasonableness

Comment 4 to section 9-610 of the UCC indicates that a secured party does not have the right to dispose of collateral '"in its then condition' under *all* circumstances." Specifically, Comment 4 provides that "[a] secured party may not dispose of collateral 'in its then condition' when, taking into account the costs and probable benefits of preparation or processing and the fact that the secured party would be advancing the costs at its risk, it would be commercially unreasonable to dispose of the collateral in that condition."

What constitutes commercial reasonableness in preparing and processing collateral for disposition is not expressly set forth in the UCC. The case law provides some context, but the conduct required of a secured party remains unclear. A general rule of thumb has developed under UCC lore: The secured creditor about to dispose of a car on default should wash the car, but probably should not overhaul its engine. This crude example is clear enough, but in between the two extremes of washing a car and overhauling its engine lies an immense middle ground, where the duties of a secured party are not so clear.

Cost Benefit Analysis

A few outlying cases in the Ninth Circuit require a secured party to use its "best efforts" to improve the

collateral, using whatever means are available to the secured party, without regard to time or expense, so that the secured party can obtain the highest price and best recovery possible upon disposition of the collateral. See, e.g., *Mitchell v. Burt & Vetterlein*, 1996 WL 144233 (9th Cir. 1996). At the other end of the spectrum, some courts have read the UCC literally and stated that "a creditor may, but is not required to, repair, improve, or otherwise spruce up collateral before it is sold." See, e.g., *C.I.T. Corp. v. Duncan Grading & Construction Inc.*, 739 F.2d 359, 361 (8th Cir. 1984).

The majority of the cases, however, suggest that secured parties should employ a cost-benefit analysis in determining whether to prepare or process collateral before disposition. Consistent with Official Comment 4 to section 9-610 of the UCC, these cases have held that a secured party must weigh the costs and probable benefits of preparation or processing of the collateral, including the fact that the secured party would be advancing these costs to improve the collateral and would be bearing the risk that the resulting increase in value of the collateral is insufficient to allow recovery of these costs--which would force the secured party to seek recovery of the deficiency through litigation with the debtor. The secured party must evaluate whether the benefit, in the form of the anticipated increase in value of the collateral, exceeds the cost of improving the collateral.

In conducting its cost-benefit analysis of whether to improve the collateral, the secured party essentially must weigh two related issues: what the secured party *must do* to avoid being held to have acted commercially unreasonably; and what the secured party *must not do* to avoid this consequence. One category of cases involves debtors who claim that the secured party improperly failed to improve the collateral. See, e.g., *Franklin State Bank v. Parker*, 346 A 2d 632, 18 UCC Rep. 266 (NJ Super. Ct. 1975); *Weiss v. Northwest Acceptance Corp.*, 546 P.2d 1065 (Or. 1976). The debtors in these cases claim that the secured party missed the opportunity to sell the collateral for more money and therefore should not be entitled to pursue the debtor for a deficiency. On the other side are cases involving debtors who claim that the secured party spent too much money improving the collateral and that the secured party's excessive preparation expenses therefore should not be properly charged against the proceeds of the sale of the collateral under section 9-615(a)(1) of the UCC. See, e.g., *First Fidelity Acceptance v. Hutchins*, 717 A.2d 437, 439 (N.J. Sup. Ct. Law Div. 1998).

The investment by the secured party must actually be expected to result in a net benefit. The secured party is required to improve the collateral if the expense and effort of preparation is small compared to the benefit of such improvement. Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, v. 1 (Third Edition). For instance, as suggested above, cleaning the collateral or conducting minor repairs to it is almost always required.

If a better price cannot be obtained after the repair than if the repair had not been undertaken, the preparation of collateral is not commercially reasonable. *Richardson Ford Sales, Inc. v. Johnson*, 676 P.2d 1344 (N.M. Ct. App. 1984). And, of course, if the cost of the repair would exceed the price that the collateral would bring at sale, a secured party cannot be expected to undertake the repair--nor should the debtor be expected to tolerate such a repair. For example, in *First Fidelity Acceptance v. Hutchins*, the Superior Court of New Jersey held that spending $1,655.33 to prepare a car for sale that would likely sell for $500 was not commercially reasonable. *Hutchins*, 315 N.J. Super. at 204, 717 A2d at 439. In addition, where the cost of improving the collateral is uncertain or expensive, or burdensome or extensive, such effort by the secured party is not required. See *Whitney Nat'l Bank v. Air Ambulance by B & C Flight Mgt., Inc.*, 516 F.Supp.2d 802 (S.D. Tex. 2007).

Work in Progress/Raw Materials

Custom in the industry is also relevant to the analysis. If the proposed preparation is customary for the type of collateral in question, it is more likely to be commercially reasonable for the secured party to do the preparation. In a Tenth Circuit case, the court found that dismantling, cleaning, and painting an oil rig before sale was a usual practice with respect to oil rig collateral and that it was not commercially unreasonable to expect the secured party to perform such acts before disposing of the collateral. *Liberty Nat. Bank & Trust Co. of Okla. City v. Acme Tool Div. of Rucker Co.*, 540 F.2d 1375 (10th Cir. 1976).

A particularly vexing issue is whether a secured party must complete production of the debtor's work in process or upgrade the debtor's raw materials. The debtor might argue that, to be commercially reasonable, a secured party must complete work in process inventory so that the secured party will end up with far more marketable and valuable finished goods. A debtor might also argue that it would be commercially reasonable for a secured party to take steps to process the debtor's raw materials to increase their value (for example, by converting less valuable insulated raw material copper wire to more valuable "pure" raw material copper wire by removing the plastic cover from that wire), even if a ready market exists for the sale of the debtor's raw materials in their existing form.

There is little case law to guide a secured party on what to do with raw materials and work in process. Nevertheless, since the bulk of the cases on post-default preparation and processing pertain to superficial repairs or clean up, one might conclude that courts would consider any significant processing of repossessed raw material or work-in-process inventory too complicated and burdensome a duty to place on a secured party. Presumably, factors such as the extent of the secured party's access to, and the cost

to the secured party of, equipment, employees, insurance, permits, utilities, and other required production elements should have a bearing on whether it is commercially reasonable to expect a secured party to process raw materials or complete production of work in process of the debtor. And if, for example, the debtor operates in an environmentally sensitive industry, a court might not find commercially unreasonable the secured party who elects not to complete the work in process or upgrade the raw materials of the debtor.

The secured party may, however, eliminate uncertainty in the collateral disposition process and insulate itself from claims of commercial unreasonableness by agreeing with the debtor in advance upon appropriate disposition mechanics. Section 9603(a) of the UCC allows the secured party and the debtor to agree as to what method of disposition of the collateral and what degree of preparation and processing of the collateral will be deemed by the parties to be commercially reasonable. Such agreement will be respected provided that the disposition standards are not "manifestly unreasonable." Rev. UCC § 9603(a). In a recent Fifth Circuit case, the bankruptcy court held that the bank's carefully constructed definition of "commercial reasonableness" and explicit authorization to sell collateral at a public or private sale at any time or place, with cash or credit bids, was not "manifestly unreasonable." *In re Adobe Trucking, Inc.*, 2011 Bankr. Lexis 4929, 76 UCC Rep.2d 365, 2011 WL 6258233 (Bankr. W.D. Tex. 2011). The court accepted such contractual provisions in the bank's credit agreement language as a guideline for commercial reasonableness, and such agreement also stated it was commercially reasonable for the bank to fail to incur expenses reasonably seen by the bank as significant in preparing collateral for disposition. However, secured parties should be careful to structure any proposed disposition arrangements as a voluntary agreement by the debtor, rather than as a waiver by the debtor of the secured party's duty, under section 9610(b) of the UCC, of commercial reasonableness with respect to every aspect of the disposition. The UCC does not permit the debtor to waive this duty of the secured party. Rev. UCC § 9602(7).

Conclusion

Comment 4 to section 9-610 of the UCC advises that courts "should not be quick to impose a duty of preparation or processing on the secured party." Rev. UCC § 9-610, Comment 4. Nevertheless, it is clear that a secured party must prepare the collateral for sale in at least some circumstances. A secured party may not rely on the plain language of section 9-610(a) of the UCC as a "safe harbor" to dispose of collateral without further consideration of whether the secured party may be required to improve its value. Instead, the secured party must be aware that section 9-610(a) does not exist in isolation, but, rather, is part of a statutory scheme that also includes UCC section 9-610(b) (which provides that every aspect of a disposition of collateral, presumably including the secured party's decision whether to improve the collateral, must be commercially reasonable) and the duty of good faith imposed by UCC Article 1 (which duty is defined in UCC section 9-102(a)(43) as including the observance of reasonable commercial standards of fair dealing). (See also Official Comment 19 to Rev. UCC § 9-102.) What constitutes "commercially reasonable" conduct by the secured party in preparing collateral for disposition is ultimately a factual question that requires a cost-benefit analysis. The secured party must conduct this analysis carefully. Failure to meet the obligation of commercial reasonableness impairs the secured party's right to collect a deficiency judgment against the debtor (Rev. UCC §§ 9-607(c), 9-626(a)(3)), and the debtor may not waive the obligation of the secured party to exercise commercial reasonableness in the disposition of collateral. (Rev. UCC § 9-602(7)). The secured party and the debtor may, however, agree as to what method of disposition and type of preparation and processing of the collateral will be deemed by the parties to be commercially reasonable. So long as such disposition arrangements are structured as a voluntary agreement by the debtor, rather than as a waiver by the debtor of the secured party's duty of commercial reasonableness, they should be enforceable.

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