PEPPERDINE UNIVERSITY

Pepperdine Law Review

Volume 1 | Issue 1 Article 10

12-15-1973

Debtor's Defense To A Deficiency Judgment Under UCC

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On an issue of first impression in California, the third Appellate District recently interpreted the Uniform Commercial Code, as adopted in California, as providing cumulative remedies to a debtor who had not received the prescribed notice. The case of *Atlas Thrift Co. v. Horan*[1] held that where a creditor has failed to give adequate notice as prescribed by Statute, the debtor has a defense to a deficiency judgment, in addition to an action for damages.

In *Atlas,* Sam Horan, operator-proprietor of a delicatessen, agreed to help his son-in-law secure financing to start a delicatessen of his own. Defendant Horan and the son-in-law negotiated for a loan with Atlas Thrift Company with whom Horan had had previous dealings and with whom he enjoyed a good financial reputation. Horan declined to sign the loan papers because of a provision in the lease on his own delicatessen which forbade him to engage in a similar business within twenty-five miles of the location. He did, however, make verbal assurances to the finance company that he was backing his son-in-law and was a "silent partner." Atlas agreed to lend $10,000 to the son-in-law without Horan's signature and, in addition filed a financing statement on the fixtures as security.

The son-in-law defaulted and the business failed. Subsequently the son-in-law went into bankruptcy. Plaintiff Atlas petitioned and obtained a release of the collateral by the trustee in bankruptcy. Atlas did not deliver personally or by mail any notice to the defendant Horan or his son-in-law of the intended sale and proceeded, after publication of the notice of sale, to "sell" the fixtures and equipment to itself at its own office, for $2000.[2] Prior to the public sale by plaintiff, Atlas had located a buyer, Opper and Silk, who had agreed to purchase the fixtures from Atlas for $5000. The arrangement was consummated at a later date. Atlas then brought suit for a deficiency against Horan and demanded the balance due

1. Atlas Thrift Co. v. Horan, 27 Cal. App. 3d 999, 104 Cal. Rptr. 315 (1972).

2. The market value of the fixtures and equipment was found by the trial court to be $12,500. *Id.* at 1001, 104 Cal. Rptr. at 316.

after default. This amounted to $15,000, offset by the proceeds of the sale, $2000.

The trial court found that the secured party, Atlas, had not complied with California Commercial Code section 9504 (3) which requires personal or mailed notice and a commercially reasonable sale.[3] It also determined that defendant Horan was a debtor within the meaning of California Commercial Code section 9105 subdivision (1) (d).[4] However, relying on out of state authority which permits deficiency judgments in spite of failure to comply with section 9504 (3) of the California Code, the court held that the remedies provided for in section 9507 for the wronged debtor are exclusive. Therefore, failure to comply with default provisions may not be raised as an affirmative defense or bar to a deficiency action.[5] The Appellate Court reversed the trial court and held that failure to give notice and to conduct a commercially reasonable sale was a bar to a deficiency judgment where raised as an affirmative defense.[6]

In 1965 California's version of the Uniform Commercial Code, including Article 9 which deals with secured transactions, became effective.[7] Section 9-504 of the Uniform Commercial Code provides that a secured party may repossess and sell his collateral if the debtor defaults.[8] However, the California version of the Uniform Commercial Code requires the secured party to give notice of the time and place of the sale, delivered personally or by mail to the debtor.[9] Every aspect of the disposition must also be con-

3. CAL. COM. CODE § 9504(3) (West 1964). The section numbers in the official text of the Uniform Code are a composite number, such as section 9-504 in which the digit preceding the dash designates the article (Division in California) in which the section appears. In the California Code the dash has been removed from the section numbers so that section 9-504 of the UNIFORM COMMERCIAL CODE becomes section 9504 of the California Code. WEST'S ANN. CAL. CODES, FOREWORD, COMMERCIAL CODE, Vol. 23A (1964).

All references to section numbers contained herein, unless otherwise indicated are to the UNIFORM COMMERCIAL CODE as adopted by the California Legislature in 1963 (Stats. 1963, ch. 819).

4. CAL. COM. CODE § 9105(1) (d) (West 1964).

5. 27 Cal. App. 3d at 1005, 104 Cal. Rptr. at 319.

6. *Id.* at 1008, 104 Cal. Rptr. at 321.

7. CAL. COM. CODE § 1101 *et seq.* (West 1964).

8. UNIFORM COMMERCIAL CODE § 9-504(1), sometimes referred to as the CODE.

9. CAL. COM. CODE § 9504(3) (West 1964); *See also* SENATE FACT FINDING COMM. ON JUDICIARY, 6TH PROG. RPT. TO THE LEGIS. pt. 1, the UNIFORM COMMERCIAL CODE, at 587 (1959-1961). Subdivision (3) of 9504 was changed in the California version by setting forth specifically what constitutes timely notice in the place of the provision of subsection (3) of section 9-504 of the Official Text which provides merely for "reasonable notice". The change was made to avoid controversy in each case as to whether the notice was reasonable by substituting a definite standard.

ducted in good faith and in a commercially reasonable manner.[10] If the secured party sells the collateral, he must account for any surplus and unless otherwise agreed, the debtor is liable for any deficiency.[11] In the event the creditor wrongfully fails to comply with the resale provisions of the California Commercial Code, the debtor or any person entitled to notification, or whose security has been made known to the secured party prior to the disposition, is entitled to recover any loss resulting from this failure.[12]

The main issue was whether the debtor, in addition to his claim for damages, may also prevent the creditor from recovering a deficiency where the secured party fails to notify the debtor before disposition of the collateral, or where the sale is not conducted in a commercially reasonable manner. In such cases, the authorities are divided over whether to indulge the secured party's claim for a deficiency.[13] In view of the lack of unanimity of interpretations by various state courts and in the absence of decisions on the point in California, the *Atlas* case arose. The pro-deficiency view, adopted by many courts, is that the secured party who fails to notify the debtor may still claim his deficiency if he can prove that the resale obtained fair value for the collateral.[14] The anti-deficiency view bars the secured party from claiming any deficiency where he fails to give proper notice.[15] This view, adopted by the Appellate Court in *Atlas,* represents a statement of the law in California.

The U.C.C. and its official comments do not discuss the relationship between the debtor's liability for a deficiency and the secured party's liability for damages for non-compliance with the required

10. CAL. COM. CODE § 9504(3) (West 1964).
11. CAL. COM. CODE § 9504(2) (West 1964).
12. CAL. COM. CODE § 9507(1) (West 1964).
13. White, *Representing the Low-Income Consumer in Repossessions, Resales and Deficiency Judgment Cases,* 3 U.C.C.L.J. 199, 220 (1971), 64 NW. U.L. REV. 808, 832-33 (1970).
14. Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 276 A.2d 402 (Dist. Ct. 1971); T & W Ice Cream, Inc. v. Carriage Barn, Inc., 107 N.J. Super. 328, 258 A.2d 162, 6 UCC Rep. Serv. 1230 (Bergen County Cts. L. Div. 1969); Weaver v. O'Meara Motor Co., 452 P.2d 87, 6 UCC Rep. Serv. 415 (Alas. 1969); Barker v. Horn, 245 Ark. 315, 432 S.W.2d 21 (1968).
15. Leasco Data Process Equip. Corp. v. Atlas Shirt Co., 66 Misc. 2d 1089, 323 N.Y.S.2d 13 (Civ. Ct. 1971); Skeels v. Universal C.I.T. Credit Corp., 222 F. Supp. 696 (W.D. Pa. 1963) *vacated on other grounds,* 335 F.2d 846 (3d Cir. 1964); Braswell v. American National Bank, 117 Ga. App. 699, 161 S.E.2d 420 (1968); Bergen Auto. v. Mattarochio, 58 N.J. Super. 161, 155 A.2d 787 (Super. Ct. App. Div. 1959).

default procedures.[16] While U.C.C. section 9-504 (2) states that the debtor will be liable for any deficiency, some courts have insisted that personal notice and commercially reasonable resale of the collateral are conditions precedent to recovery of a deficiency judgment.[17] These courts rule that notice is essential since without it, the debtor has been denied the right of redemption given him by section 9-506.[18] In addition the courts reason that U.C.C. section 9-507, which does provide remedies for the wronged debtor, has nothing to do with defenses to a deficiency action but is intended only to provide an affirmative cause of action for a loss that has already been sustained—not a substitute for a defense to an action for a deficiency.[19]

In *Atlas,* the California Appelate Court based its opinion on the general construction provisions of the U.C.C., prior California case law, recent case law from out of state and the U.C.C. default provisions themselves.

The Court cited section 1-102 of the Uniform Commercial Code, which provides in subsection (1); "This Code shall be liberally construed and applied to promote its underlying purposes and policies." Subsection (2) (c) states "Underlying purposes and policies of the Code are . . . to make uniform the law among the various jurisdictions." The Court then quoted § 1-103 of the Code, stating in effect that unless displaced by particular provisions of the Code, the prior commercial laws supplement the Code provisions. The conclusion of the Court was that U.C.C. § 9-507 is not expressly made an exclusive remedy and does not purport to have any bearing on deficiency judgments.

For California pre-code precedent, the Court referred to two cases: *Methany v. Davis*[20] and *Rocky Mountain Export Company v. Colquitt,*[21] recalling that under California chattel mortgage law, a mortgagee who disposed of mortgaged property after default without following the notice requirements of the statute and the mortgage was barred from recovering a deficiency judgment.

Out of state precedent principally relied on by the Court was the

16. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, 44.9.4 at 1262 (1965).

17. Edmondson v. Air Service Co., 123 Ga. App. 263, 180 S.E.2d 589 (1971); Climonetto v. Keepes, 501 P.2d 1017 (Wyo. 1972).

18. UNIFORM COMMERCIAL CODE § 9-506.

19. Braswell v. American Nat'l Bank, 117 Ga. App. 699, 161 S.E.2d 420 (1968); Leasco Data Process Equip. Corp. v. Atlas Shirt Co., 66 Misc. 2d 1089, 323 N.Y.S.2d 13 (Civ. Ct. 1971); Foundation Discounts, Inc. v. Serna, 81 N.M. 474, 468 P.2d 875 (1970).

20. 107 Cal. App. 137, 290 P. 91 (1930).

21. 179 Cal. App. 2d 204, 3 Cal. Rptr. 512 (1960).

1971 New York case of *Leasco Data Process Equipment Corporation v. Atlas Shirt Company Inc.*[22] This case arose from an action to recover a deficiency judgment by a secured creditor who sold leased property after repossession. The New York Court held that failure of the secured creditor to notify the debtor, after repossession, of the time at which the equipment was to be sold to the highest bidder precluded the creditor from recovering a deficiency judgment.[23] The carefully written opinion relied on earlier New York case law. It stated that prior to passage of the Code in New York, the common law rule was: "In the absence of contractual provisions, the obligation of the debtor was terminated when the conditional vendor repossessed."[24] Similarly, the anti-deficiency principal became firmly established in New York as it had in virtually all states which had adopted the Uniform Conditional Sales Act. The right of the conditional vendor to secure a deficiency judgment was dependent on precise compliance with statutory requirements as to notice.[25] *Leasco* went on to draw three distinctions as to cases in which different conclusions had been reached in other jurisdictions.[26]

First the *Leasco* Court concluded that none of the decisions from other jurisdictions referred to the presence in that jurisdiction of a settled interpretation of the corresponding provisions of the Uniform Conditional Sales Act, such as existed in New York. While these pro-deficiency decisions took notice of a comparable body of law in their jurisdictions, the Court felt that the failure to refer to it and to describe how it had been changed by the new statutory language surely undermined its authority.

Secondly, the New York Court stated that none of the opinions undertook a detailed textual analysis of the Code. Elaborating, *Leasco* asserted that U.C.C. § 9-507 makes no direct allusion to the circumstances under which a right to a deficiency may arise. It emphasized the language in § 9-507 used to articulate the affirmative action phraseology, as well as the complete lack of defense terminology found there. The Court then concluded that § 9-507 was only intended to provide an affirmative action, that it was far more

22. 66 Misc. 2d 1089, 323 N.Y.S.2d 13 (Civ. Ct. 1971).
23. *Id.*
24. *Id.* at 1090, 323 N.Y.S.2d at 15.
25. *Id.*
26. *Id.* at 1092-3, 323 N.Y.S.2d at 17.

probable that the authors of the Code never contemplated that a secured party could recover a deficiency judgment after violating the statutory command of notice.

Finally, the New York Court asserted that out of state courts reaching the above conclusion were so disturbed by the harsh and unfair consequences following deficiency judgments that strenuous judicial efforts were made to mitigate these consequences. The most common formula was to create a presumption that the repossessed item had the value of the outstanding debt and to place upon the secured party the burden of proving a different value.[27]

Endorsing the New York Court's analysis, the California Court in *Atlas* affirmed that consideration of "the most natural and reasonable construction of the statutory language in the light of the legal background, the realities of the relationship involved between secured creditors and debtors who have defaulted and their respective financial resources for engaging in litigation, all lead to the conclusion that *the right to a deficiency judgment depends on compliance with the statutory requirements concerning dispositions and notice.*"[28]

In barring a creditor's right to a deficiency judgment where California Commercial Code protections of notice to the debtor and commercially reasonable sale are not followed, the courts have provided greater motivation to the creditor to secure the best possible price, (which presumably is most likely to result from a commercially reasonable sale of the secured collateral). The remote and unrealistic threat of an action for damages under U.C.C. section 9-507 from a pressed and defaulting debtor by itself is not enough to ensure significant efforts to maximize proceeds of the sale. If deficiencies were allowed under these conditions, a creditor might well prefer to sell quickly to friends or to himself (as in the *Atlas* case). His bonus or reward could well be to make auction fees, cement business friendships with distress sale buyers, and then to collect his deficiency. California's affirmative defense should go far to inhibit sharp practices by unscrupulous secured parties.

As to the California Commercial Code requirement of personal notice to the debtor of intended sale, the opportunity to redeem seems only equitable. It is a matter of due process and consonant with constitutional principles of justice and fair play. Though notice may seem futile and a holdover from three centuries of

27. *Id.* at 1093, 323 N.Y.S.2d at 17.
28. 27 Cal. App. 3d at 1009, 104 Cal. Rptr. at 321 (1972).

equity court protections of mortgagors, it is still desirable.[29] Increased debtor education and sophistication plus wider availability of credit provide the debtor with the opportunity to search for a retail bidder for his repossessed property or to make a last-ditch effort to raise money for redemption.

In a recent study by P. Shuchman, *Profit on Default; an Archival Study of Automobile Repossessions and Resale,* it is suggested that resale procedures themselves should be the focus of the courts attention rather than the denial of creditors' deficiencies.[30] This approach seems unrealistic, for it is difficult for court-made law to embrace the varying types of commercial practices in a piecemeal approach. If regulation of the resale procedures is to be effected, it should be comprehensively designed by legislatures or the U.C.C. should be amended to enunciate, as the California Court has done, the right of the debtor to an affirmative defense when Code safeguards are not observed.

California, by providing debtors with this affirmative defense, has gone a long way to motivate creditors to carry out the spirit and letter of the Uniform Commercial Code and to guarantee an opportunity to the debtor to redeem or at least to enjoy the benefits of a commercially reasonable resale.

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29. 2 GILMORE, *supra* note 16, 44.2 at 1216.
30. 22 STAN. L. REV. 20 (1969).