

FARM LEGAL SERIES

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Foreclosure of Security Interests in Personal Property

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INTRODUCTION

Lenders typically require borrowers to pledge property (or collateral) to secure the loan. Collateral is real or personal property owned by the borrower that is pledged to the lender as security for the repayment of the debt obligation. For further discussion, see *Financing the Farm Operation; Contracts, Notes and Guaranties; Mortgages and Contracts for Deed*; and *Security Interest in Personal Property*. In the event of default, the lender may look to the collateral to satisfy the debt.

The process of foreclosing a mortgage in real property and foreclosing a security interest in personal property are very different. In this fact sheet, we will discuss the options available to creditors with a security interest in personal property and review the procedures under Minnesota law that are required to foreclose a security interest in personal property. For further detail on mortgage foreclosures, see *Mortgage Foreclosures*.

DEFAULT

Acts of Default

In order for a lender to exercise its rights under a security agreement, the debtor must have, in fact, defaulted on his obligations. The Uniform Commercial Code (UCC) contains no definition of default, but allows default to be defined by the parties to the transaction in their documents. As a result,

virtually every security agreement contains a broad definition of events that constitute a default. Such events include the failure to make an installment payment when due, the sale of collateral without the creditor's prior written consent, the failure to keep the collateral adequately insured or the occurrence of any other event that causes the creditor to deem itself insecure.

Acceleration Clause

Both the promissory note and the security agreement will generally contain an acceleration clause. This clause allows the creditor to demand payment of the loan in full upon the occurrence of any event of default.

SECURED PARTY OPTIONS AFTER DEFAULT

Once a default has occurred, there are a number of options available to the secured party. Not all of these options involve the enforcement of the security interest under the UCC.

Continued Operation of the Farm

In the case of a farming operation, if the primary collateral consists of growing crops, the secured creditor will likely refrain from exercising the right to foreclose upon the crops until the debtor has harvested them. By waiting until after the harvest, the secured creditor generally will be in a much better position than if it enforced its rights immediately upon default. As a result, even though a default may exist, the secured

creditor may actually make additional advances to allow the farmer to continue to operate long enough to harvest the crops.

Allow for Voluntary Sale of Collateral

A second option is to allow the debtor to sell the collateral on his own. The secured creditor may think that a better price can be obtained for the collateral if the sale is held directly by the borrower.

Workout Agreement

A third option, especially in the case of farming operations, is the workout. The typical workout arrangement usually involves other creditors besides the secured creditor. The workout arrangement includes both an extension of time and a payment by the debtor of less than the full amount owed, but occurs outside the formal structure of the bankruptcy court. The purpose of a workout is to restructure the debt to enhance the chances of continuing the business and ultimately repaying all creditors. In some cases, the secured creditor may conclude that its position will be enhanced by encouraging the continuation of the business as a growing concern when compared with what it would receive from the liquidation of the collateral.

Seek Money Judgment

A fourth option available to the creditor is an action against the debtor on the underlying debt. In such a case, the creditor is subject to the rights and duties as set forth in another fact sheet in this series, *Rights of Unsecured Creditors*. This option may be followed when the secured party suspects that the collateral is insufficient to satisfy the unpaid balance of the debt. It is attractive to the secured party, however, only if the debtor has unencumbered nonexempt assets that can be reached to satisfy the underlying obligation. A lender is often hesitant to only seek a money judgment against the farmer, since by making the election to only seek a money

judgment the lender may be precluded from foreclosing its security interest in any personal property.

Foreclosure of Security Interests in Personal Property

The final option is the substance of this fact sheet. The lender may look to the personal property for repayment of the debt.

REPOSSESSION

If the secured creditor determines that it prefers to repossess and sell the personal property collateral, it must comply with state law. The UCC, however, is clearly drawn with the protection of the secured party in mind. Once default—as defined by the creditor in the security agreement—occurs, the creditor can repossess the collateral. After repossession, the creditors can dispose of the collateral by public or private foreclosure sale, retain the collateral in satisfaction of the debt, terminate the debtor's right of redemption, add the costs of repossession and foreclosure to the unpaid balance of the debt and pursue the debtor for any remaining unpaid balance or deficiency.

The first step in this process, however, is the repossession of the property. Repossession can either be voluntary (by agreement) or involuntary (by self-help or by court action).

Voluntary Agreement

The first method, and the method initially explored by most lenders, is to negotiate an agreement with the debtor to cooperate voluntarily in a turnover of the secured property to the lender. In fact, in many cases, the sale of the secured property may even be conducted on the debtor's premises. Doing so may be advantageous to the debtor. Since all reasonable expenses of foreclosure (including storage, sale preparation, labor, trucking, repairs, advertising, auctioning, clerking and legal expenses) are added to the

secured debt, the debtor may only be increasing his liability to the lender by not cooperating with the sale.

Involuntary Foreclosure

If the debtor is unwilling to voluntarily turn over secured property to the creditor, the creditor will need to take action to obtain the property. Where the collateral is property used in the farming operation, including equipment, crops and livestock, or where it is serving as collateral on a loan used for farm operations, it is deemed agricultural property. Minnesota's farmer-lender mediation statute generally requires the creditor to offer mediation of the debt to the debtor prior to initiating an action to repossess such property. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires, among other things, that a creditor seeking to repossess agricultural property first send notice to the debtor and offer the debtor the opportunity to mediate a resolution to the debt prior to beginning such action. If the debtor elects to mediate the debt, the creditor's repossession of the property can be suspended for a period of up to 90 days pending completion of the mediation. Where the debt involved has been scheduled by the debtor in a bankruptcy or involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the creditor can enforce seek repossession of the property without first offering mediation.

Self-Help Repossession

The secured creditor may repossess the collateral by self-help and without first obtaining a court order so long as no breach of the peace occurs. The UCC contains no definition of breach of the peace, and many courts have struggled with defining it. In

general, a secured party may not break any locks, use any physical force, issue any threats or proceed in the face of any commands from the debtor, his family or other representatives to stay away or otherwise refrain from removing the collateral.

Court Action

If self-help is unavailable, the secured party must initiate a court action to obtain possession of the property. In Minnesota, this action is known as a replevin action or action for claim and delivery. Such a lawsuit is an action to obtain the immediate possession of personal property. In most cases, a secured party may obtain possession of personal property over the objections of the debtor only after the debtor has received notice and a hearing. If, at the hearing, the secured party demonstrates that it will succeed at a formal trial in establishing its claim to the property, the court will order the sheriff to seize the property on behalf of the secured party prior to conclusion of a trial on the matter.

If, however, the court finds that (1) the debtor has a defense to the secured party's claim, (2) the debtors interests cannot be adequately protected by a bond filed by the secured party and (3) the harm suffered by the debtor would be greater than the harm suffered by the creditor if the property were not delivered to the creditor prior to a final decision, the court may allow the debtor to retain possession of the property until conclusion of the trial. If the court finds that the debtor is entitled to retain possession, it may require the debtor to make a partial payment of the debt, post a bond or make the property available for inspection. The court can make any other provision that it deems fair. If the court determines that the creditor is entitled to possession of the property, the creditor must post a bond with the court that is one and a half times the fair market value of the property.

In some cases, it may be possible for a creditor to obtain a court order allowing it to obtain possession of the property without notice and a hearing. To do so, however, the creditor must: (1) demonstrate to the court that it has made a good faith effort to inform the debtor of the hearing or that informing the debtor of the hearing would endanger the ability of the creditor to recover the property; (2) that it has shown that it is entitled to possession of the property; (3) that the debtor is about to remove the property in question from the state or to conceal, damage or dispose of the property; or that due to other circumstances the creditor will suffer irreparable harm if it does not obtain possession of the property prior to a hearing. Even in such cases, a hearing must be held at the earliest practicable time.

AFTER REPOSSESSION

Once the creditor has obtained a court order, it has the right to repossess and remove the collateral from the debtor's premises. This is usually done by an order for the sheriff to seize the property and return it to the creditor. Once the creditor takes possession of the property, it may either sell the property and apply the proceeds to the debt, or keep the property to satisfy all or part the debt. The creditor is responsible for storing and taking good care of the collateral pending sale. It also must provide all labor and trucking.

FORECLOSURE SALES

As soon as the secured lender has possession of the property or knows that it can deliver possession to buyers, it will usually arrange to liquidate the collateral.

Commercially Reasonable

The UCC requires that any sale held by a creditor be held in a commercially reasonable manner. The UCC does not define

“commercially reasonable,” so it varies with the circumstances of each case. It does not require a sale at the highest possible price, but rather that the price is obtained after conducting the sale in a way that is “commercially reasonable under the circumstances.” Considerations such as the kind of collateral; its condition; the number, location and identity of likely buyers; seasonable markets; and all other factors that would be considered by a reasonable commercial seller selling such items without regard to any foreclosure would be considered by a court in determining whether a sale was held in a commercially reasonable manner.

Type of Sale

The law allows either a public or private sale. Based on the facts of each case, the lender must determine which is commercially more reasonable. Certain items of collateral—such as grain, which has a recognized market price—may be more appropriate for a private sale. Similarly, if the collateral consisted of livestock that couldn't be sold on the debtor's premises, but were so numerous that they couldn't be kept elsewhere pending a public sale, a private sale would be the likely choice. In most situations, however, a well-advertised public auction generally is the preferred method of sale.

Notice

Regardless of the type of sale, the lender must provide reasonable notification to the debtor and any other secured creditor before any sale. Ten days is considered reasonable notification. The notice generally tells the debtor what will be sold; whether the sale will be public or private; the date, time and place if it is a public sale or the date after which such sale will take place if it is a private sale; the amount of the secured indebtedness; a statement that the debtor may redeem the collateral by paying the

indebtedness and expenses in full before the date of the sale; and how the sales proceeds will be applied.

Application of the Proceeds

Once the sale has been held, the law sets forth the order in which the sales proceeds will be applied to the various claims. This order is as follows:

1. Reasonable expenses involved in the repossession and foreclosure, including reasonable attorneys' fees and legal expenses if provided for in the security agreement;
2. Satisfaction of the foreclosing creditor's debt or agricultural liens.
3. Satisfaction of indebtedness held by subordinate secured parties.

If there is money left over, the surplus must be turned over to the debtor. If, however, there is still a balance owed to the foreclosing creditor, the creditor can pursue the debtor for the remaining balance due. This remaining balance is called a "deficiency." The secured creditor's right to pursue a deficiency may be restricted by a court if the creditor has not followed the procedures of the UCC in foreclosing its security interest. If a deficiency judgment is sought, the secured creditor must follow the procedures set forth in the fact sheet, *Rights of Unsecured Creditors*.

KEEPING THE PROPERTY

The secured creditor may, in some circumstances, retain the collateral in partial or full satisfaction of the underlying debt rather than sell the property. Provided the debtor has not paid 60 percent or more of the debt, or has signed a statement waiving his right to require a sale of the property, nothing in the law prohibits this and nothing in the law requires a secured creditor to sell the collateral.

To retain the collateral, the secured creditor must send a written notice of his proposal to the debtor and any other secured party which has given the creditor written notice of an interest in the collateral. Upon receipt, the debtor and such other secured parties have 20 calendar days to object to the retention of the property by the secured party. Upon objection, the secured party must dispose of the collateral according to the rules set forth above. If no objection is made, the creditor takes title to the collateral and cuts off the debtor's right to redeem the collateral. The creditor can also claim a deficiency against the debtor if the debtor receives from the creditor, and consents to, a written proposal that the creditor will accept the collateral in partial satisfaction of the debt. All other secured parties must also consent to the proposal.

RIGHTS OF REDEMPTION

A debtor or any other secured party has the right to redeem, or get back, the collateral. In order to redeem, the debtor or other secured party must pay the creditor the amount owed on the debt and pay the expenses incurred for taking, holding, and preparing for disposition and, if included in the security agreement attorneys' fees. The debtor or other secured party must exercise this right before the creditor has disposed of the property, contracted to dispose the property, or accepted property in full or partial satisfaction of the debt.

CREDITOR MISBEHAVIOR

If a creditor does not comply with the rules of the UCC, the debtor may seek appropriate sanctions from a court. Such creditor misbehavior may consist of repossession prior to default, repossession with breach of the peace, failure to conduct a sale in a commercially reasonable manner, failure to notify the debtor in advance of the sale,

holding an improper strict foreclosure or obtaining a price that is too low. One sanction that can be obtained in some cases is an injunction against the foreclosure. A debtor must move quickly, however, and must realize that obtaining an injunction may be difficult. A second sanction, available when the disposition already has occurred, is the recovery of damages in an amount equal to any loss caused by failure to comply with the rules of the UCC.

CONCLUSION

The foreclosure of a security interest in personal property under the UCC involves many steps. The events triggering default, the nature of the collateral and the relationship of the parties all contribute to how a foreclosure occurs. The law, however, is designed to aid and assist the secured creditor in exercising its collection rights.

For more information:
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