Repossession and Sale After Default: An Old Remedy Under Fire

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EACH BUSINESS DAY in the United States, thousands of lenders are actively engaged in making secured loans to be used for the purchase of the vast variety of higher cost goods available on the American markets. In a large percentage of these loans the item purchased is used as security for the loan made to enable the purchase of it—a practice that is in widespread use at the present time.[1] By this means the businessman is able to purchase the computer that he needs in his factory or finance his inventory—and the consumer is able to purchase a new car, a color television set and a washer and dryer.

In turn, those who manufacture and market the wide variety of goods available today rely heavily upon personal property secured loans, both at the dealer "floor plan" as well as the retail level. This is necessary in order to keep the goods moving from the factory, through the marketplace, to the ultimate user. It logically follows that the legal machinery by which these loans become operational is of key importance to all involved: the manufacturer to make certain that his operations will be financed; the wholesaler and retailer who must look to these loans for their income; the businessman-consumer who uses this means to obtain the goods needed; and the lender who relies upon the interest earned from these loans as a healthy addition to income. Each relies heavily

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[1] In many loans the lender will make a "pledge" of other personal property as security for the loan. This is often done where there is a small down payemnt or perhaps none at all.

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upon the other and in practice the procedures work well. Since all of this is true, it logically follows that those who rely upon personal property secured transactions also rely upon the legal procedures that permit repossession and sale in those instances where a buyer-debtor defaults on his obligations. It also follows that any legal attack upon these procedures would be of interest to those who rely upon them. If such an attack should prove successful in the courts, it could be viewed as a threat to the whole concept of personal property secured transactions. That threat is now present.

Therefore, the purposes of this article are, first, to examine the repossession procedures that are routinely used in personal property secured transactions. Next, to take a look at recent legal attacks upon these procedures; and finally, to see if a reasonable prognosis can be made to determine what the future may hold for repossession and sale as used in secured transactions. First, it is helpful to examine the basic procedures of both secured personal property lending as well as those followed in repossession and sale.

Where Are the Basic Procedures Found? At the heart of each secured transaction one will find three articles of the Uniform Commercial Code: (1) Article 2, Sales; (2) Article 3, Commercial Paper; and (3) Article 9, Secured Transactions. In addition, other laws are directly involved—and especially where the buyer-debtor is a consumer. Examples include "Truth in Lending" and the "Fair Credit Reporting Act."[2] The most important of the three Uniform Commercial Code articles to the lender is Article 9. Many books and articles are available on this subject[3] and the filing, description and other requirements will not be discussed here. However, the importance of complying with these requirements at the time of the loan cannot be overemphasized. This is true because the lender who complies as provided by law is able to perfect his security interest in the collateral involved—a very desirable position for the lender to occupy.

In addition to complying with the perfection requirements of Article 9, lenders use two other techniques to gain additional security: the first is practical in nature, the second, a pure product of law. First, the lender usually requires that the buyer-debtor make a down payment on the item that is being financed. The percentage of the down payment in relation to the purchase price may be as high as one third or even one-half of the purchase price—or as low as five percent. But regardless of the down payment required, the outlay of money from the pocket of the buyer-debtor gives him an equity in what he is buying. This in turn encourages him to meet the balance of the obligation

[2] Title I (Truth in Lending) and Title VI (Fair Credit Reporting Act) of the *Consumer Credit Protection Act,* 15 U.S.C. §§ 1601–13, 1631–41, 1671–77 and § 1681 (1971).

[3] *See* Goodwin, *Anatomy of the Financing Statement,* 7/1 Am. Bus. Law J. 29 (1969).

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because of the loss that he will suffer if he does not. Second, it is customary for the lender to reserve the right to repossess the goods (collateral) used as security in the event of the default of the buyer-debtor. The lender will sell the goods as provided by Article 9 and apply the proceeds to the debt owed. If the proceeds are sufficient to pay off the obligation, then the lender has been fully restored. If not, the lender has the right to sue for the balance due and can then look to other assets of the buyer-debtor for recovery of the balance.

The statutory law that permits repossession upon default is almost uniform in 49 of our 50 states. It reads in part as follows:

> Unless otherwise agreed a secured party has on default the right to take possession of the collateral.[4]

Because of the wording of this statute it is important that the parties agree that the lender is to enjoy the right of repossession. This agreement is customarily found in the security agreement making this right a pure matter of contract law.[5]

In addition, the parties must further agree just what events will be treated as "default." This is necessary because the Uniform Commercial Code does not define "default," leaving its definition to the parties. In the customary security agreement, events that constitute default include: (1) failure to make the payments when due, (2) failure to properly insure the collateral against loss, (3) failure to properly care for the collateral, and any other event that may be relevant to the particular situation at hand.[6]

Once default occurs, as defined by the parties in the security agreement, the lender through agents (often professional agents) will take possession of the collateral.[7] However, the U.C.C. makes it clear that the lender is not free to repossess under any and all conditions. Uniform Commercial Code, §9–503, continues:

> In retaking possession, a secured party may proceed without judicial process if this can be done without breach of peace or may proceed by action.

Thus upon the happening of any of the agreed "default contingencies" the

[4] UNIFORM COMMERCIAL CODE § 9–503.

[5] For the requirements of a valid security agreement, *see* UNIFORM COMMERCIAL CODE § 9–201.

[6] In the typical mass-produced form security agreement, it is not uncommon to find a long list of events that will be treated as default if any of them occur. In many, if not most, secured transactions the buyer-debtor never reads these provisions and could thus be in default under certain conditions without, in fact, knowing it. In addition, many of these default terms bear no relation to the collateral being financed. This hardly seems fair to the buyer-debtor and a proper court attack could upset this practice.

[7] In pre-U.C.C. days, the controlling law in most states was found in Sections 16 and 17 of the Uniform Conditional Sales Act. Under this law, title to the goods never passed to the buyer until the full purchase price had been paid.

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secured party may take immediate possession of the collateral and may then exercise the rights that he has to sell the goods and apply the proceeds to the obligation.[8]

The sale after repossession must follow certain guidelines. Some examples include (1) the sale may be public but it can also be private; (2) the lender may have reasonable repairs made to the collateral at the expense of the buyer-debtor in order to assure maximum sales return; (3) the sale must be held within a reasonable time after repossession, thirty days being typical; (4) if the buyer-debtor has paid sixty percent of the cash price or sixty percent of the loan due, then specific guidelines must be followed which will not be discussed here.[9] In short, the procedures for private repossession are clearcut and favor the lender. Because of this simple fact, very few challenges have been made to them in the past, and less have been successful. However, in an attempted private repossession, if a "breach of the peace" is threatened—or is a possibility—then the careful lender must back off and use those procedures provided by the statutes in each state.[10]

Once a breach of the peace occurs—or is threatened—the secured party must "proceed by action." In most states, this means that the lender must initiate a replevin or detinue action to recover the goods. Under the typical state statute, the lender summarily files the proper papers in the office of the clerk or other functionary of the nearest circuit court. The lender then sets a value upon the collateral sought and upon the posting of a bond in double this amount, the clerk or other functionary will issue an order to the sheriff to take the collateral into possession. This procedure is ex parte and the buyer-debtor will not necessarily know that it has occurred until the sheriff or his deputy shows up to take possession. The "breach of peace" provision does not apply now because if the buyer-debtor resists the sheriff, he will be arrested for resisting a judicial officer. While the typical state statute permits the debtor to post a counter bond and regain possession of the collateral until a hearing on the merits can be held, it can be seen that the initial taking under the court order is quite possibly a "taking of property by the state without due process"

[8] Uniform Commercial Code § 9–503 also provides that upon demand the debtor will assemble the collateral and make it available at an agreed location. This is widely used in the repossession of heavy construction equipment and complex machinery installed in factories.

[9] See Uniform Commercial Code, § 9–505.

[10] The courts have started to spell out what a "breach of the peace" in fact means. The cases make it clear that it can be almost any overly-aggressive act or threat by the repossessing agent—as well as almost any protest by the buyer-debtor no matter how feeble. For example, in a recent Ohio case it was held to be a breach of peace to repossess a farm tractor over the very mild protest of the buyer's young son, the buyer not being present at the time. Morris v. First Nat'l Bank & Trust Co., 21 Ohio St. 2d 25, 50 O.2d 47, 254 N.E.2d 683, 7 U.C.C. Rep. 131 (1970).

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—and therein lies a constitutional issue. Do the replevin statutes of the states violate the Fourteenth Amendment of the United States Constitution?

The United States Supreme Court in two cases decided on June 12, 1972, held that the replevin statutes of Florida and Pennsylvania are unconstitutional.[11] The court ruled that the repossession procedures discussed above violate the Fourteenth Amendment of the United States Constitution since property of the debtor is taken by the state (through a state officer) prior to a hearing upon the right of the lender to have that possession. The constitutional defect is found in the fact that the buyer-debtor only has the right to be heard *after* the repossession and not before.

The impact of these decisions is not clear at the moment. But what is certain is that before any repossession can now be lawfully carried out by the state (through an officer such as a sheriff) the debtor must first be given notice plus a chance to have a judge or justice of the peace hear preliminary evidence as to whether or not the secured party is "probably" entitled to have such possession. At the moment, absent actions by the state legislatures to create such procedures, those who want to repossess in this manner are going to have to engage in some speculation.

For example, even if a debtor who is in default is given notice and a chance for a hearing, he is not likely to appear—unless he has some defense such as defects in the product or perhaps an error on the part of the secured party. The giving of notice and the requirement of setting a hearing may delay the repossession for weeks or months. In addition, if there is any chance that the debtor might destroy the collateral or leave the jurisdiction with it, what then? Upon a proper showing to a judge, will an order for repossession be issued without notice and hearing for the debtor?[12] It can also be presumed that a spiteful debtor might harrass a secured party by legal action regardless of the procedures that he might follow—and especially so if his lawyer is clever enough.

All of this seriously detracts from the security that lenders have enjoyed in the past and leaves many questions unanswered. However, since the U.S. Supreme Court ruled only as to action by the *state* in repossessions, are lenders still free to proceed after default by *private* repossession? Even here, many questions are now unanswered.

Five cases recently decided in various courts illustrate that problems also exist where repossession after default is carried out by private methods. These problems are two in nature: first, practical dangers that accompany repossession of personal property where the buyer-debtor has no notice that the goods are going to be taken, and second, the Fourteenth Amendment constitutional

[11] Fuentes v. Shevin, 407 U.S. 67 (1972).

[12] This would not be unlike the issuance of a search warrant after a showing of probable cause to a judicial officer.

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issue. The following cases provide good examples of the practical problems that can arise in "no notice" private repossession.

The "Night Rider" case.[13] In this Missouri case the opening words of the circuit judge set the background against which the court rendered its decision:

> When Vern Klingbiel (purchaser), went outside his home in St. Louis, Missouri, on the morning of June 22, 1966, he found his brand new (1966) Ford Galaxie 500 gone. Later he was to learn that in the dark of the night and with skillful stealth the car—despite it being fully locked—had been taken away, not by some modern auto rustler, but by an anonymous representative of the Automobile Recovery Bureau acting for Commercial, the installment finance company, which was described with remarkable accuracy as a "professional firm." Little did he know that with this sudden, unexplained disappearance of an automobile, which—with all its chrome and large mortgage—was still his, so much was unleashed. First, of course, was his anguish at his loss. More significant for us, time, tide, litigation, trial, victory and appeal was to instruct him in the intricacies of the fine print of the purchase of mortgage contract he signed and, perhaps to his awe, the Uniform Commercial Code.[14]

The court ruled that since the buyer-debtor was in fact not in default on the contract as far as payments were concerned, and since personal property within the car at the time of repossession had not been returned to him, that the verdict of the jury in the lower court which gave him actual and punitive damages, was not erroneous. The upper court rejected the argument of Commercial that it had become "insecure" and had foreclosed for this reason.[15]

The "Missing Diamonds" Case.[16] In this case the secured party who had repossessed the automobile was found guilty of conversion of diamond rings that were in the glove compartment of the auto in spite of the fact that the secured party did not know of the presence of these rings. Judgment for the plaintiff in the sum of $2,145 was sustained.

Turning now from the practical problems of private repossession, what have the courts had to say about whether or not private repossession, when carried out without notice or hearing, violate the Fourteenth Amendment? As it turns out, the courts have held both ways. Three cases must be examined—the first brought the issue into the open.

The "Opening Shot."[17] In this case the automobile in question had been repossessed privately while the debtor was at work so the repossession had been

[13] Klingbiel v. Commercial Credit Corp., 439 F.2d 1303, 8 U.C.C. Rep. 1099, (10th Cir. 1971).

[14] *Id.* at 1305.

[15] Under the UNIFORM COMMERCIAL CODE § 1–208, a note-holder may foreclose if he has reason to believe that his security has been—or might be— impaired and he has reserved this right in the note itself.

[16] Varela v. Wells Fargo Bank, 8 U.C.C. Rep. 1106 (Cal.Ct.App. 3rd Dist., 1971).

[17] McCormick v. First Nat'l Bank, 322 F.Supp. 604, 9 U.C.C. Rep. 137 (S.D.Fla. 1971).

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"peaceful." The plaintiff-buyer then sought to invoke the jurisdiction of the federal court alleging that a cause of action accrued to him under the Fourth, Fifth and Fourteenth Amendments of the United States Constitution, since an automobile is a "specialized type of property" and that by retaking it without notice, he had been denied property without due process thus triggering the protection of 28 U.S.C. §1331, and the Civil Rights Act, 28 U.S.C. §1343 and 42 U.S.C. §1983. The plaintiff argued that since the lender had incorporated the repossession and sales provisions from the state statutes into the contract with the plaintiff, this was sufficient "color of state law" as required by the Civil Rights Act to give the court jurisdiction.

After examining the facts and allegations the court concluded that an automobile is "no more than a piece of property" and that it had not been repossessed under color of state law as alleged, and since the retaking had been peaceful it amounted to the lender simply using a remedy that it had reserved in the first place by contract with the buyer-debtor. The court was unwilling to hold that U.C.C. §9–503[18] was enough "color of state law" to permit the court to take jurisdiction under constitutional principles.

In short, the court held that the constitutional prohibitions apply to "state action" and have no application between private individuals and firms and their private contacts. This seemed to settle the issue.

The Second Round. However, a federal judge in California had other ideas in the next case,[19] and ultimately the constitutional issue will have to be settled by the U.S. Supreme Court. The case arose out of what appeared to be an ordinary repossession of secured collateral—but with one variation. The buyer-debtor did not like what happened to him and he decided to do something about it. Off to court he went.

The first question faced by the court was whether or not it had jurisdiction under the United States laws cited in the *McCormick* case.[20] The court ruled that it did have jurisdiction since the lender incorporated the repossession and sale provisions of the state statutes into the contract with the buyer-debtor and that this was sufficient "color of state law" as required by the Civil Rights Statutes. The court then turned to the second question—is a state statute (U.C.C. §§9–503 and 9–504) exempt from "constitutional scrutiny" merely because its operation is confined to situations involving the presence of a contract?

First, the court pointed out that the United States Supreme Court in *Sniadach v. Family Finance Corp.*[21] struck down the Wisconsin wage-garnishment statute as "allowing" a taking of property without due process since the

[18] FLA. STAT. ANN. § 679.9–503 (1966).
[19] Adams v. Egley, 338 F. Supp. 614, 10 U.C.C. Rep. 1 (S.D. Cal. 1972).
[20] *Supra* note 17.
[21] 395 U.S. 337 (1969).

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law made no provision for notice and a hearing before the wage attachment was made. Next, the court pointed out the similarity of the *Sniadach* holding to the facts in the present case and concluded that U.C.C. §§9–503 and 9–504 as they appear in the California Statute[22] are unconstitutional—and thus void —since in both cases property had been taken without prior notice and a hearing.

In justification of its decision, the court made two important points; first, the court stated:

> If the policy underlying the decision in Sniadach is to provide some extra modicum of legal protection to those who live on the lower economic margins of our society, it would be illogical for the courts to be dissuaded from applying that policy by the presence of standard-form contracts which often operate most harshly on the poor . . .[23]

and, second, other items had been taken with the automobile in question that had not been covered in the security agreement between the parties.

Thus, we have two decisions reaching two different conclusions upon almost identical facts and law. But to make the matter even more interesting, another federal court in California, in a decision rendered just seventeen days after the Adams decision, refused to be bound by the ruling of his fellow judge.

Oller v. Bank of America.[24] In this repossession and sale case the judge dismissed the action, stating in part:

> What we have here is a private act taken by a private organization to protect its security interest in personal property that is subject to a conditional sales contract. The courts have been almost uniform in refusing to color such transactions as 'State actions . . .' It is difficult to imagine any statutory provision that does not, in some way, control human relationships. To say, as plaintiff seems to contend, that all human behavior which conforms to statutory requirements is 'State action' or is 'under color of State law' would far exceed not only what the framers of the Civil Rights Act ever intended but common sense as well.[25]

And so the private repossession issue is joined by two federal district judges in the same state—California. The facts in each case are close enough to say that they are on "all fours"—and the rulings in each case are perfect opposites. So where do we go from here?

If the Adams decision ultimately stands, it may mean that every legal act performed between private persons in any contract situation must necessarily involve the state, thus triggering constitutional protections as well as other Federal laws. In addition, this would probably cause an undermining of the

[22] Cal. Comm. Code §§ 9503, 9504 (West 1964).
[23] Adams v. Egley, 338 F.Supp. 614, 621, 10 U.C.C. Rep. 1, 9 (S.D. Cal. 1972).
[24] 10 U.C.C. Rep. 877 (N.D. Cal. 1972).
[25] *Id.* at 879.

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security that lenders have enjoyed in the past in personal property secured transactions. And this may have the long-range effect of causing serious harm to those who rely upon such financing.

On the other hand, perhaps the problem could be solved completely by quick and positive action by the various state legislatures. Since all states are now forced to create new replevin procedures—or abandon the remedy—it might be wise for them to create statutes that would regulate the procedures in both "public" as well as private repossessions. These statutes would provide for notice plus a hearing for the debtor before a proper judicial officer of the state before any repossession was carried out.

Yet, such statutes would *not* have to be created for private repossessions, if private repossessions are not in fact unconstitutional. And herein lies a dilemma: how will we know until the question has been passed upon by the high court? If the court should declare private repossessions to be simply a matter of private contract between the parties, then present procedures in the states will not have to be changed. But if the ruling should be the other way, then new procedures will have to be created.

From a practical law-making point of view, it might be best for each state to create new statutes that would bring their replevin procedures in line with the recent rulings of the Supreme Court—but *not* change the existing procedures for private repossession. This would seem to be in order because there are at least two good reasons to believe that the high court will not upset private repossessions if and when the issue is before it.

First, the *Fuentes* case was decided by a vote of 4 to 3. Justices Burger, Blackmun and White dissented in favor of the present replevin procedures in the states of Florida and Pennsylvania. Recent Nixon appointees, Rehnquist and Powell took no part in these decisions. Thus, if the same matter was presented to the court as it is now constituted, it is quite possible that the decision would be 5 to 4 in *favor* of the prior replevin procedures.

Second, on the same date as the replevin decisions, the high court, with Powell and Rehnquist taking part in the decision, decided a case involving the refusal of admission of a black to the Moose Lodge No. 107 at Harrisburg, Pennsylvania. The court held that the refusal of admission did not violate the Fourteenth Amendment since the amendment applies only to actions by the state—and not to acts of private individuals.[26] While this decision had absolutely nothing to do with private repossession, it certainly indicates the views of the present court as those views relate to private acts of individuals as opposed to acts of a state.

Ironically, the case that placed private repossession upon a collision course with the Fourteenth Amendment (*Adams v. Egley*) contains a statement by the judge who wrote that opinion which provides some insight into what the

[26] Moose Lodge No. 107 v. Irvis, 92 S.Ct. 1965 (1972).

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ultimate ruling on the question might be. The judge is speaking of his ruling that declared U.C.C. §§9–503 and 9–504 to be unconstitutional. He seems to be telling us that in his own heart he believes his decision to be wrong:

> Although such a conclusion appears incumbent on this court given its view of the applicable law, it is reached with no small measure of reluctance. While I applaud any effort to secure for the poor and helpless the enjoyment of their constitutional rights, it is not clear that the present trend of judicial thinking will ultimately have this effect. For those who make an earnest effort to maintain their payment schedules and default due to circumstances beyond their control, creditors have traditionally exercised considerable flexibility and have exhausted every reasonable alternative before resorting to the drastic and expensive remedy of repossession. These persons, the ostensible beneficiaries of Sniadach, and its progeny, stand to suffer substantially in the long run, if sellers and creditors raise their prices and interest rates commensurate with the cost of the judicial process which these decisions make necessary. Further, this court cannot help but note the increasing segment of our population which has deliberately chosen to live on the lower rungs of the economic ladder, whether out of revulsion against the materialism of society or out of lack of ambition and commitment. For these reasons, whether repossession is summary in nature or the result of judicial process will, in most instances, have little significance. Whether or not the benefits of the present decision will prove sufficient to outweigh the possible costs remains to be seen.[27]

Conclusion. And so a new legal skirmish line has been formed and the opening shots have been fired—but seldom do two or three battles decide a war. Only time, and perhaps chance, will decide the fate of an old legal remedy —private repossession and sale. In the meantime, the security enjoyed by the personal property secured lender in the past has been placed into a position of uncertaintly at the present time.

[27] Adams v. Egley, 338 F.Supp. 614, 622, 10 U.C.C. Rep. 1, 10 (S.D. Cal. 1972).

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