

Conducting Business With Auction Companies

Assessing Your Risks and Implementing Protective Procedures

It is common practice among equipment dealers to attempt to move slow selling used inventory off the lot to an auction company or equipment jockey for what is hoped to be a much quicker sale. Unfortunately, as many dealers have discovered, this method of moving inventory can place the dealer at risk of losing such equipment without payment if the auction company or equipment jockey is in financial difficulty or unscrupulous.

Although many auction companies run successful and honest businesses, a dealer is exposed to many risks when he transfers equipment to an auction company. The following is a list of the most significant risks:

Transfer to a Third Party – If an auction company sells a dealer’s equipment to a third party purchaser and the purchaser acquires the equipment in good faith, the dealer will have a difficult time attempting to recover the equipment from the purchaser even though (a) the dealer is not paid by the auction company, or (b) the dealer had a security interest in the equipment.

Bankruptcy/Insolvency of Auction Company – Even if the auction company has been paid by a third party, the auction company may use the proceeds to pay another creditor and not have funds to pay the dealer. Moreover, if the auction company pays a dealer for his equipment and then files bankruptcy, this payment may be subject to a claim by the bankruptcy trustee and may be required to be returned to the bankruptcy estate of the auction company to be shared among all creditors.

Violation of Dealer Floor Plan – If equipment transferred to an auction company is currently on the dealer’s floor plan, the dealer will likely be in breach of the terms of the floor plan documents. Most floor plan arrangements will only permit transfers of inventory to customers in the ordinary course of business. Even though many manufacturers are aware that transfers to auction companies occur, lender awareness should not be relied upon as permission to transfer equipment to an auction company. Without permission, a dealer will be in default under his floor plan. The consequences of a breach of the floor plan can be significant. First, if a dealer is not paid for his equipment by the auction company, the floor plan lender will have the right to require the dealer to immediately pay the lender the floor planned amount for such equipment, and, perhaps, all other amounts currently outstanding under the floor plan. Second, if such a dealer is also experiencing a period of difficult relations with a manufacturer and his floor plan is with the manufacturer or a manufacturer affiliate, a default under the floor plan will give the manufacturer “good cause” to terminate his dealership. This is significant because a manufacturer is required to demonstrate “good cause” before it may terminate its relationship with a dealer.

Protecting Dealer Interests

As the previous section illustrates, the risks involved in conducting business with an auction company can be significant. Therefore, if a dealer is going to conduct business with an auction company, it is important to take measures that will provide more protection in the event a problem arises.

The protective measures discussed below assume that the dealer is not demanding cash on delivery, retaining possession of the equipment until the sale by the auction company is completed and/or accompanying the equipment to the auction.

Obtain Insurance Coverage: One of the easiest things that a dealer can do is make sure that his insurance policy covers losses arising from fraud or deceit. The benefit of this type of measure is that the insurance coverage will provide the dealer protection regardless of the type of transaction (e.g., consignment versus sale)

or the auction company with whom the problem arose. Notwithstanding the foregoing, please note that insurance may not always adequately protect a dealer's interests. Insurance coverage will likely protect a dealer if his equipment is lost due to an unscrupulous auction company. However, if no fraud or deceit is involved and an auction company is simply unable to pay a dealer due to financial difficulties, insurance will not provide protection.

Document the Transaction: It is important that each transaction is documented in writing and signed by the auction company. In addition, please state whether the transaction involves a sale to the auction company or simply a consignment. Even if a dealer is not retaining security interest (discussed below) with respect to the equipment, it is important that the transaction is documented so that a dealer's claim against the auction company is clear if a dispute arises.

Retain a Security Interest: If a dealer is selling equipment to an auction company on credit, the dealer may retain a purchase money security interest (a "PMSI") in the equipment. A PMSI will give the dealer priority over all other secured creditors of the auction company with respect to amounts owed to the dealer with respect to that piece of equipment. To obtain such a security interest, a dealer must follow the steps outlined below:

- Execute a security agreement with the auction company before the equipment is transferred. Provisions sufficient to create a security interest can often be included in a form purchase order.
- File a UCC financing statement with the Office of the Secretary of State for the state in which the auction company is incorporated if the auction company is a corporation. The financing statement must be filed before the auction company takes possession of the equipment.
- A signed written notice must be given to every other secured creditor of the auction company who has a security interest in the auction company's inventory if such secured creditor filed a UCC financing statement before the dealer files his UCC financing statement. The written notice must state that the dealer has acquired a security interest in inventory of the auction company and that the inventory covered is made up of certain types of equipment (e.g., agricultural equipment) sold to the auction company by the dealer. This notice must be received by the other applicable secured parties before the auction company receives possession of the equipment (but not more than five years before the auction company receives the equipment). This requirement means that the dealer will have to conduct a UCC search against the auction company after the dealer files his UCC financing statement.

The good news is that if a dealer is sending multiple pieces of the same general class of equipment to an auction company over a period of time, the process outlined above is only required with respect to the first transfer of equipment, subject to the following exceptions: (a) the dealer must obtain a signed security agreement from the auction company for each transaction and (b) if the dealer is transferring equipment to the auction company more than five years after the first UCC financing statement was filed, the dealer will need to repeat the process outlined above.

If the dealer is engaging in consignment transactions with an equipment jockey (i.e., someone who brokers equipment transactions as opposed to transfers of equipment via auctions) instead of an outright sale, he must comply with rules similar to those set forth above for obtaining a security interest. Taking these steps will give the dealer a superior right to his equipment over the claims of credits of the equipment jockey. Because it is very important for a dealer to comply with all of the steps set forth above to obtain the security interest and consignment protection discussed above, please consult an attorney to assist in setting up these transactions.

The primary benefit of the protections outlined in this section is that to the extent the equipment is still owned by the auction company or owned by (or consigned to) the equipment jockey at the time of default, a dealer will have a right to that equipment that is superior to all other creditors. Unfortunately, it is likely that once the equipment has been transferred to a third party who purchased the equipment in good faith, the security interest will no longer be effective to recover the equipment. However, the security interest will continue in the sale proceeds. In addition, if the auction company is paid by cash or check contemporaneously with the transfer, the

dealer's security interest in the sale proceeds will be superior to all other creditors. If the auction company accepts payment after the sale (e.g., 3- day terms or a promissory note), the dealer will not have the first priority to those proceeds if another creditor already has a security interest against the accounts receivable of the auction company. Therefore, if the dealer's UCC search turned up such a creditor, he may want to require the other creditor to subordinate to his security interest before transferring any equipment to the auction company.

When the UCC was recently revised, the definition of consignment was changed to state that a consignment did not include a transfer to an auctioneer. As a consequence, if a dealer is simply transferring possession of equipment to an auction company for sale at an auction, the dealer should not have to protect himself against creditors of the auction company by complying with UCC. Instead, these transactions will generally be covered by the common law, which gives the dealer a superior right to his equipment as against creditors of the auction company.

However, a dealer should protect himself by clarifying in writing that the transaction is not a sale and specifying that the auction company may not grant a security interest in the equipment to the auction company's creditors. In addition, if the auction company also operates a dealership or serves as an equipment jockey, a dealer is advised to comply with the UCC for maximum protection in case it is later determined that the auction company does not qualify as an "auctioneer" due to the fact that auction operations may not constitute its primary business. Please note that a dealer will still be subject to the UCC if he sells the equipment to the auction company.

Miscellaneous Protective Measures

In conjunction with the main protective measures discussed above, there are several other measures that may also be taken. The following lists a few of these additional protective measures. However, please realize that the willingness of an auction company to agree to certain of these items will depend on the value of the amount of equipment the dealer is transferring/consigning to the auction company. In addition, the real key to many of these protective measures is that they provide a dealer with the means of keeping tabs on the auction company that hopefully functions as an early warning detection system.

- Require the auction company to accept only a two-party check from the purchaser of the equipment.
- Require all proceeds from the sale of the equipment to be deposited in a separate account. Withdrawals from this account should only be authorized by a joint order from the dealer and the auction company.
- Establish a floor price for each piece of equipment.
- Require quick payment terms by the auction company regardless of whether the Auction Companies equipment is sold to a third party.
- If a dealer is transferring multiple pieces of equipment to one auction company, state in the documentation that a default with respect to one piece of equipment is a default with respect to all equipment. This will enable the dealer to seek the return of all of his equipment if one or more payment defaults makes him suspicious.
- Require the auction company to comply with state laws that require signs indicating that items offered for sale are owned by third parties. A sign requirement may at least aid the dealer by alerting potential creditors of the auction company that the auction company does not have title to all of the equipment offered for sale on its lot.
- Require weekly or monthly reports on the status of the equipment. Alternatively, or in conjunction with the reports, periodically check in at the auction company's location to verify the presence of the equipment.
- Obtain a personal guaranty from the individual owners of the auction company and their spouses.
- Require the auction company to obtain a surety bond in the amount of the floor price for the equipment.
- Require the auction company to maintain property and casualty insurance on the equipment and a commercial general liability policy in such amounts as the parties agree is appropriate. Periodically

obtain proof of such insurance or require prior notice from the insurance company of cancellation of such insurance.

Trust, Trust, Trust

Although the protective measures outlined in this article will decrease a dealer's risk in conducting business with an auction company, there is always a chance that the auction company will simply ignore the requirements imposed on it, transfer the equipment, and potentially leave the dealer high and dry. Thus, to a large extent, a dealer really cannot justify the risk involved in this kind of transaction unless he has a high degree of trust in the auction company. If a dealer has not had prior exposure with an auction company, the best approach is to start slowly with smaller pieces of equipment to see if the auction company can earn his trust.

Reporting Problems with Auction Companies

If you are having problems with an auction company, please contact I-NEDA at 515-223-5119. Your Association can investigate your problems, provide you with assistance, and notify other dealers in an effort to prevent a problem from becoming widespread.

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