

***A good working knowledge of the UCC is critical to your auction business.***

The Uniform Commercial Code (“UCC”), in conjunction with state specific laws, and your contracts, govern the rights and obligations of buyers and sellers of vehicles and other goods. Perhaps most importantly for the auction business, the UCC also governs the rights of lenders and borrowers in secured transactions like flooring, float arrangements and other delayed payment arrangements. If you extend credit to a dealership, the UCC governs your rights to reclaim the dealership’s assets, including its inventory of motor vehicles, in the event the dealership does not or cannot repay the debt. Holding the paper titles is a good idea, but it is not enough to protect you in the event the dealer fails to pay. A small investment in time to make sure that your documents and procedures are in order can pay big dividends if a dealer defaults on your agreement.

***Why you, and your staff, need to know how to properly create and perfect security interests.***

If you provide financing to buyers you probably have some form of security agreement. You may have had the form documents drafted or reviewed by your lawyer at some point in the past, but typically it is your staff that inserts debtor names, addresses and other critical information into the agreement and other forms, and then files some type of financing statement (commonly a “UCC-1”) to perfect your security interest. The UCC can be hyper-technical with respect to perfection of security interests in collateral, and if you make a mistake in creation or perfection, you may lose priority to another creditor or a trustee in bankruptcy, even if you provided financing for the automobiles that are the collateral. The good news is that once you know how to create and perfect a security interest, it is easy to establish routine procedures to make sure it is done right, each and every time.

Because state laws vary on how an auction must perfect an interest in motor vehicles, and those rules often change if the motor vehicles are held as inventory, you need legal advice specific to your state as to how to perfect your interest in motor vehicles. You may need to note your security interest on the title to vehicles such as tow trucks, trailers, and vehicles used in the business, but not held for sale, and then file a UCC-1 to cover vehicles held in inventory. Here are a few important points to consider in having your documents reviewed and in creating procedural steps to guide your staff:

1. Get the accurate name(s) and addresses of the debtor(s) from your state’s corporation division or equivalent, and make sure they match *exactly* on the security agreement and UCC-1. Don’t assume the debtor has listed either the name or the form of entity accurately on auction registration documents. Trade names are not sufficient. Consider requiring all principals of the dealer to sign and/or personally guaranty the security agreement as co-debtors, and list them as co-debtors on the UCC-1. The rule of accuracy applies to individuals. The UCC generally requires that the debtor’s name be *exactly* as it appears on a current driver’s license issued by the state.
2. Check the UCC office to see where you will be in priority before you enter the into the security arrangement. Don’t assume that if a prior filed creditor has been paid, they no longer have a security interest. Generally speaking, first in time, first in right. Know where you stand in priority *before* you offer financing.

3. Make sure that there is an express grant of a security interest in collateral in the agreement and that the definition of collateral is extremely broad. You can always decide at a later time not to exercise your rights as to some items of collateral. “All assets” or “all property” is not sufficient. The definition of collateral in the security agreement should always include proceeds and insurance policies and proceeds, and should match the description on the UCC-1. Beware of using a new form of security agreement with an old form of UCC-1, the definitions of collateral will likely not match.
4. File in the right place- states vary on what address you must use for the debtor (principal place of business, or location of collateral) and where you must file a financing statement to perfect an interest in collateral. You may have to file in more than one place if the security agreement covers things like fixtures. If the debtor is not located in your state, you will likely have to file it as required in the state where the debtor is located.
5. Debtor’s names often change and UCC-1’s expire. If a debtor changes its entity name, amend your UCC-1 to include that new name as an additional co-debtor. Make sure you have calendared to renew UCC-1’s before they expire.

***Want Super-priority? How to create and perfect a purchase money security interest.***

One exception to the first in time, first in right rule, is the purchase money security interest (“PMSI”) rule. Generally speaking, a PMSI secures repayment of credit that allows a debtor to acquire goods, including vehicles that are part of the debtor’s inventory. A perfected PMSI has priority over all other conflicting security interests, *including* prior filed security interests. This super priority extends to identifiable proceeds of purchase money collateral. There relatively few additional steps you need to take to acquire a perfected PMSI, and they are relatively simple. Here is a short list of the important steps to turn your perfected security interest into a perfected PMSI:

1. Make sure that the security agreement identifies the security interest as a *purchase money* security interest.
2. Perfect your security interest *before* the debtor takes possession of the vehicles in which you want to create a PMSI.
3. Search the UCC records for prior conflicting security interest holders, and give an authenticated (signed) written notice to each holder of a prior filed UCC-1. The notice must state that you intend to acquire a purchase money security interest in the debtor’s inventory, and must describe the types of inventory, which is generally vehicles, parts and accessories, and proceeds thereof, including proceeds of insurance.
4. The authenticated notice must be *received* by the prior security interest holder within 5 years before the debtor takes possession of the vehicle, so it should be mailed in a manner that allows you to prove receipt by the prior secured creditor.

***For more detail about the UCC please read the following memorandum prepared by our legal counsel***

## **What is the Uniform Commercial Code (“UCC”)?**

The UCC is a comprehensive set of laws that govern commercial transactions and business dealings. As with most “uniform” codes, the concept is that most or all states adopt the uniform code in whole, or at least substantially unchanged, in order to create a harmonized set of laws and regulations across the country for interstate commerce activities involving contracts for transfer or sale of real property and the supply of goods, financing mechanisms, leases, security instruments and other matters. Nearly every state in the country has adopted the UCC in some form. As a threshold matter, then, it is critical that every auction understand that it must have a working knowledge of the specific commercial codes enacted in the states in which the auction operates and in the states in which its potential customers/buyers/debtors are registered to do business (e.g., corporations) or where the unregistered businesses have their principal place of business (e.g., partnerships). Finally, the UCC must be applied in conjunction with other relevant local, state and federal statutes and regulations.

## **Why is the UCC important for auctions?**

Generally, wholesale consignors transfer personal property (e.g., automobiles; boats; recreational vehicles) to an auction. Often, the auction is selling “straight cars” (autos ready for resale and driving) or “total loss autos” (autos used primarily for salvage and parts) to dealers or salvage companies. Here we will focus on the auction (as lender and creditor) relationship with the dealer (as borrower and debtor) for the sale of “straight cars.” Depending on the state, the auction may be briefly in the chain of title for the autos.<sup>1</sup> In other states, the auctions are not in the chain of title and therefore do not have any right or title to the vehicles. In either scenario, however, auctions may provide financing for dealers in exchange for which the auction takes a security interest in vehicles the dealer purchases on credit.

Accordingly, the UCC may be important for an auction that extends credit to a buyer and therefore the auction wants to secure a priority lien position on the autos that it sells to the dealer. Should the dealer fail to make full payment for the financed autos, the auction will likely want to repossess some or all of the purchased autos from the dealer. However, for dealers with troubled credit, there may be other parties that also have an interest in the auction-financed autos such as floor-plan lenders, other dealer creditors and downstream third-party buyers. The auction, therefore, needs to ensure that it “perfects” a priority security interest so that the auction can legally repossess the auto free and clear of other creditors or, at least, repossess with the confidence that it has a strong position vis-à-vis other potential secured parties and creditors. More specifically, the auction should obtain execution by the dealer of a written security agreement with a provision that authorizes the auction to file a financing statement, also known as a UCC-1, in order to perfect its security interest in the autos until the dealer makes full payment on all of the autos its purchases from the auction.

If the auction complies with the UCC and other relevant state and federal statutes, most often including Certificate of Title Acts (“COTAs”) and bankruptcy laws, those first priority security interests or liens should continue to encumber the autos until the debt is paid or until severed by a buyer in the ordinary course of business (“BIOC”). In the case of a purchase by a BIOC, depending on state law and the language of the security instruments, the security interest in the auto and its COT may be severed but the floor plan lender or auction creditor may still have a security interest in the proceeds of sale. In such a case the BIOC’s retail lender’s purchase money security interest may then attach and be perfected as a first priority lien on the auto and its COT.

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<sup>1</sup> In some states the auction was actually in the chain of title so the title is actually transferred from the wholesaler to the auction to the dealer. There the dealer would then have rights in the collateral that it could transfer to the secured party (the auction). In other states it might be that the wholesaler retains the certificate of title (“COT”) and then releases the COT to the dealer upon payment by the auction to the wholesaler and the auction is never actually in the chain of title and the dealer-buyer does not actually have rights in the COT at the time it purports to transfer those rights to the secured party. This issue is important because the dealer debtor must have “rights in the collateral or the power to transfer rights in the collateral to a secured party.” UCC 9-509.

## **What might affect the position of the auction vis-à-vis buyer dealers, floor plan lenders and downstream third-party buyers of the collateral?**

**Issue:** Auctions use a number of ways to ensure payment from dealers for the autos purchased at the auctions. If an auction allows a dealer to take autos on credit, the UCC security instrument is one mechanism for auctions to maintain a priority security interest in the autos. The question then is against whom is the auction competing for priority interest in the auto and how does an auction create such an interest?

**Analysis:** The security interest can be of great value for the auction in several situations where the dealer does not pay fully for the autos and the auction wants to repossess the purchased autos.

1) Dealer. Clearly if a dealer fails to pay for the autos and there are no other parties with liens on the dealer's inventory, an auction's perfected security interest allows for a relatively straightforward repossession of the collateral.

2) Floor Plan and Other Lenders. More often, however, floor plan lenders and other lenders have security interests in some, or all, of a dealer's inventory, along with interests in other equipment, fixtures, accounts, chattel papers, documents, instruments, insurance proceeds, sales proceeds and other assets. If the floor plan lender, for example, has a higher priority lien position or perfected security interest than the auction, an auction may not be able to repossess an auto and its COT. This situation may arise when a dealer fails to pay for a certain purchase and the auction attempts to repossess the auto, or this may arise when a dealer files for bankruptcy and all of the dealer's assets are held in trust with claimants lining up to get paid. Accordingly, the auction, as a seller of goods on credit to the buyer dealer for its inventory,<sup>2</sup> must ensure it perfects a Purchase Money Security Interest ("PMSI") in the specific vehicles sold in order to trump the general security interest that the floor plan lender may have in the dealer's inventory. UCC § 9-103. If, in a search of UCC filings in the jurisdiction of concern, the auction identifies other filed financing statements that assert an interest in after-acquired inventory, the auction will need to send written notice to that secured party of the auction's PMSI. Otherwise, once the purchased auto is delivered to the dealer and becomes part of its "inventory," the other secured party (such as a floor plan lender) may enjoy a superior priority interest.

3) Downstream Third-Party Buyers. In yet other situations a buyer dealer may serve merely as a middleman and sell the auto to another merchant for sale to consumer buyers. In that instance, the issue is whether the downstream buyer is a BIOC. The critical point is that if the third party

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<sup>2</sup> In *Brasher's Cascade Auto Auction v. Valley Auto Sales and Leasing*, 119 Cal. App. 4th 1038 (Cal. App. 5th Dist. 2004), the auction (Brasher) had a preprinted dealer registration form that the dealer was required to fill out to do business with the auction that stated that the dealer would "honor promptly all checks and drafts presented for payment for vehicles purchased at Auction." Additionally, Brasher provided financing for dealers that were required to execute a "4-Week Float Pre-Authorization Request". That legal instrument required the dealer to pay Brasher at the earlier of either 28-days from the date of purchase or when the subject vehicles were sold to third parties. "Specifically, the preprinted form document used in the Float Program provides in part: 'Applicant hereby agrees that if approved, undersigned shall leave a signed business check or a signed sight draft the day of the sale for all float vehicles purchased. Payment will be held: A) until Dealer requests vehicle title B) until 4-WEEK float period expires C) upon next subsequent sale of said vehicle, whichever occurs first.'" *Brasher's Cascade Auto Auction v. Valley Auto Sales and Leasing*, 119 Cal. App. 4th 1038, 1044 (Cal. App. 5th Dist. 2004).

purchaser can establish that it qualifies as a BIOC under Section 9-320 of the UCC, then any security interest that the auction has in the auto and its COT may be severed.

Thus, a perfected security interest provides important protections for an auction that extends credit to dealers. For the auction to perfect its security interest or its PMSI, a security agreement is the start point. In fact, a security agreement is one of at least three requirements for “attachment” to the collateral (the autos purchased at auction). UCC §§ 9-201, 203. Attachment is discussed more fully in a following section, but generally value must be given by the dealer to the auction (security interest) and the dealer must have rights in the collateral (COT for the subject autos). Among other matters, these security agreements should include language such as: “Dealer authorizes Auction to file a UCC-1 financing statement and any and all other filings necessary to perfect Auction’s security interests with Dealer.” This language, and other specific language, must be present in the security agreement in order to allow for automatic blanket filings. The auction, particularly in states where the auction holds the COT pending full payment by the dealer for each of the autos purchased, immediately files a UCC-1 financing statement in the state(s) in which the dealer is registered to do business (e.g., corporation) or where the unregistered dealer (e.g., partnership) has its principal place of business. The filing of the UCC-1 financing statement then “perfects” the security interest. UCC §§ 9-301, 9-303. Perfection is discussed more fully below.

**Conclusion:** The takeaway is that if an auction allows a dealer to leave its premises with purchased autos (and in some circumstances the respective COT) without payment by cash, certified funds or a bond that covers the entire purchase value, the auction places itself in a position where it has little recourse other than filing a breach of contract action if the dealer fails to make full payment on the purchase. A lawsuit and judgment may be of little value if the dealer subsequently files for bankruptcy and there are other lenders or parties with secured interests in the dealer’s inventory and proceeds. Consequently, it is critical for each auction, under the applicable laws of its own state and the states where its buyer dealers are registered and/or have their principal places of business, to ensure that the dealer gives the auction a security interest in purchased autos so that the auction can attach to the collateral (auto COT, proceeds of sale, inventory and potentially other assets) and then perfect its interest. A security interest gives the auction a fighting chance to get paid if the dealer defaults.

## **How does an auction “attach” to the autos it sells on credit to a dealer?**

**Rule:** Section 9-203 of the UCC outlines the steps necessary for a security interest to attach to collateral so that the security interest becomes enforceable against the debtor. In general, Section 9-203 provides that a security interest is enforceable only if: “(1) Value has been given; (2) The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) One of the following conditions is met: (A) The debtor has authenticated a security agreement that provides a description of the collateral...” *Id.* See also UCC § 9-509.

**Analysis:** Let us assume that value has been given and that the auction has rights in the collateral and focus strictly on the third requirement – that the dealer must authenticate a security agreement that provides a description of the purchased autos that serve as collateral. Pursuant to Section 9-509 of the UCC, the auction may not file an initial financing statement (or any amendments thereto) unless the dealer (debtor) executes a security agreement that both authorizes filing of the UCC-1 financing statement and sufficiently describes the collateral in the agreement. Importantly, the security agreement needs to be more detailed than the UCC-1 financing statement. At minimum, the security agreement should refer to “all equipment, inventory, accounts and sale and insurance proceeds.”

**Conclusion:** the auction should discuss with its legal counsel the following points concerning a security interest in the autos the auction sells to a dealer on credit:

- Drafting a security agreement to use with all of the dealers to which the auction will extend credit or where the dealer guarantees full payment of future debts (e.g., drafts or checks issued by the dealer payable to the auction).
- At minimum, the security agreement must include:
  - o The full legal name of the dealer (if a registered organization, ensure the name is exactly as shown on its certificate of formation; if an unregistered organization, ensure the name is exactly as shown on the organization’s formation document);
  - o A description of the nature of the credit relationship or guaranty by the dealer;
  - o An authorization from the dealer that the auction may file a UCC-1 financing statement and any other filings necessary to perfect the auction’s security interest;
  - o A sufficient description of the collateral (e.g., “all equipment, inventory, accounts and sale and insurance proceeds”); and
  - o Authentication by the auction and an authorized representative of the dealer.

## **How does an auction use the UCC Financing Statements (aka. UCC-1) to “perfect” its security interest in the autos purchased at the auction?**

**Rule:** Sections 9-502 and 9-516 of the UCC, along with other more detailed instructions in other sections, specify the requirements for a financing statement. In general, the financing statement must include:

- Debtor’s full legal name (matching the exact name on the security agreement);
- Debtor’s address;
- Identification of whether the debtor is an individual or an organization;
- If an organization, specify the type (corporation; limited liability corporation; partnership; etc.); and
  - o If a registered organization, identify the jurisdiction in which the organization is incorporated or organized.
  - o If an unregistered organization such as a partnership or unincorporated entity, identify the jurisdiction of the principal place of business, or if the entity has multiple places of business, the jurisdiction of its chief executive office.
- Secured party’s full legal name;
- Secured party’s mailing address;
- Description of the collateral; and
- Any other required content as specified by individual state commercial codes.

**Analysis:** It is important for auctions to understand that these requirements are not only important for the auction to “perfect” its interest so that it can secure a first position security interest, but also so that any other party that checks a state database can clearly identify the auction as a secured party and its position relative to other potential lien creditors, bankruptcy trustees and general claimants. In large part, this process is about notice to all players in interstate commerce. To that end, it is also important for auctions to also consider the following:

- Amendments. Many commercial codes require a secured party to amend its financing statement upon 1) change of location of the secured party or the debtor, 2) change of name of the secured party or the debtor, and 3) change of ownership of the secured party. Importantly, these changes may also require filing the financing statement in a new jurisdiction and the secured party must refer to the initial filing or risk the amendment converting to an initial filing and thus losing its priority (to other intervening creditors).
- Lapsing of Effectiveness. Secured parties must familiarize themselves with the period of effectiveness for the perfected filing as many states will have a set period of effectiveness from the date of filing, but allow for filing of continuation statements within certain windows. The UCC, for example, has a five (5) year period, with the ability to file a continuation statement within six (6) months of the date of expiration. UCC §§ 515, 516.
- Notice to Other Parties. Various instances may arise that require a secured party to give notice to other secured parties listed in the UCC filings of the secretary of state’s UCC database. For example, an auction that files a PMSI may need to provide notice to a secured party that has an interest in after-acquired inventory where the auto sold by the auction to the dealer becomes part of the dealer’s inventory upon delivery to the dealer.

**Conclusion:** While “perfecting” a security interest may appear simple, ensuring “perfection” requires meticulous attention. It is imperative that auctions seek advice from lawyers well-

versed to help the auction create proper documentation and follow proper procedures to maximize the achievable protection against a defaulting debtor. Having appropriate documents filed in the proper manner, also serves to give notice to other creditors of the auction's security interest.

\*\*This article was prepared by the National Auto Auction Association's legal counsel for educational purposes only and should not be relied upon by provide readers with legal advice. Any reader who is interested in further exploring the topics discussed in this article should contact a practitioner in their home state for specific legal advice.