

BEWARE: A DEALER WILL BE LIABLE TO THE CUSTOMER'S BANK IF THERE IS A LIEN ON THE CUSTOMER'S TRADE-IN

By Jack Selzer of Seigfreid, Bingham, Levy, Selzer & Gee, P.C.

All dealers accept trade-ins from customers. Some customers may have financial problems or are one bad drought away from financial problems. Almost all farm and construction equipment customers have liens against some or all of their assets. Without taking the precautions outlined in this article, this set of facts can lead to serious trouble for a dealer. In short, if a dealer accepts a trade-in from a customer that is subject to a lien, the general rule is that the dealer will be liable to the customer's bank for the value of the trade-in if the customer defaults on his loan.

We are aware that many dealers, knowingly or unknowingly, accept trade-ins from customers that are subject to a bank lien. When we talk about liens, we are not only referring to specific liens on the trade-in, but also the silent, but deadly, blanket lien that a customer gave the bank to secure an operating line of credit. Fortunately, in most cases, the customer does not default on his loan and the bank does not have motivation to seek out a dealer that has the bank's collateral. However, if a customer does default on his loan, a dealer will get an unwelcome surprise when the dealer becomes the subject of a lawsuit and faces potential damages equal to the value of the trade-in. In addition, if the customer is in bankruptcy, the dealer will not even have any recourse against the customer. We have seen this happen recently so pay attention – it could happen to you!

Why is a dealer liable to the bank?

The Uniform Commercial Code (UCC) was developed to give secured creditors (banks) protection by establishing rules designed to provide certainty to the banks with respect to the collateral the banks take when making loans to dealers and their customers. In the case of the trade-in problem, the UCC says that the bank's lien stays with the equipment after it is traded to the dealer unless the dealer is a "buyer in the ordinary course". Unfortunately, a dealer cannot be a "buyer in the ordinary course" unless the seller (the customer) typically sells that type of equipment. The problem is that the customer is not in the business of selling equipment – that is the dealer's business. What this means is that the bank's lien remains attached to the trade-in after the dealer takes title.

If the lien stays on the equipment, it means that the bank is entitled to the value of the equipment to satisfy the customer's debt to the bank. If the bank comes after the dealer for this amount, the dealer will be hit twice – first, by giving the customer credit for the trade-in value by reducing the cash purchase price for the new equipment and second, by paying the bank cash of approximately the same amount. This is unfair, but it is the law and dealers must be aware of this potential trap.

What steps can dealers take for protection from this situation?

Dealers can limit their potential exposure in this type of situation by taking the following steps:

- Ask the customer if he has any liens on the trade-in (including any blanket liens given to a bank).
- Conduct an on-line UCC search against the customer to determine if any liens exist (see next section for more details).

- If it is determined that the trade-in has one or more liens against it, the trade-in should not be accepted unless the bank or other creditor gives its written consent to the transfer of the trade-in free and clear of the lien. If asked, the bank will normally consent because the customer is getting replacement collateral with equity available to the bank that is equal to the value of the trade-in.

At a minimum, a dealer should always ask a customer if a trade-in is subject to any liens. However, it is strongly recommended that each dealer also do a UCC search since UCC searches can now be done quickly on-line and for a reasonable cost.

What steps should a dealer take to perform a UCC search?

UCC searches used to take time. However, UCC searches can now be conducted quickly on the Internet for minimal cost. The attached document describes the process for on-line UCC searches for the following states: Arkansas, California, Colorado, Illinois, Kansas, Missouri, Nebraska, Nevada, New Mexico, Oklahoma, Texas, Utah and Wyoming. Unfortunately, neither California nor Illinois provide for on-line UCC searches so the use of a third party search service is required to get results within 2-3 days. The attached document contains contact information for the third party search.

A UCC search must be conducted under the exact name of the person/entity that owns the equipment. A search against a person's d/b/a will not reveal all liens against the owner.

As a practical matter, a UCC search will only be needed in the state in which the dealership is located. However, you are well advised to follow the rules listed below to determine the appropriate state for the UCC search:

- If the customer is a corporation, limited partnership or limited liability company, search in the state in which the customer is incorporated. Please note that this may not be the state in which the customer's operation is located.
- If the customer is an individual, search in the state where the customer resides.
- If the customer is a partnership, search in the state where the partnership has its principal place of business.
- Until July 1, 2006, a UCC search must also be conducted in the state in which the equipment was located in the four months prior to the trade-in date. This search rule is required because we are currently in the middle of a transition between two versions of the UCC.

If the UCC search identifies a lien against "equipment", "machinery", "tractors", "all personal property" or the specific piece of equipment, the trade-in will be covered by the lien and written consent from the bank or other creditor must be obtained. The consent can be as simple as a one-sentence letter authorizing the trade and stating that the traded equipment will be transferred free and clear of the bank's lien.