

Dealer Financing Documents: Avoiding Collateral Description Dilemmas

Most dealerships obtain financing from a variety of sources. Dealers may have an operating line of credit from a local bank, multiple floor plan providers for wholegood purchases and direct financing from suppliers for equipment and/or parts. Normal finance documents include some type of security interest granted by the dealer to the lender. A dealer must pay particular attention to collateral descriptions when multiple financing sources are involved. Financing documents also contain a list of breaches that constitute events of default. The list typically includes allowing a conflicting security interest in a lender's collateral. Because the national floor plan providers and many equipment manufacturers over-reach on collateral descriptions, it is all too easy for a dealer to inadvertently commit an event of default on other loans including operating lines of credit. Each of the various financiers has a legitimate interest in obtaining security for payment, but these interests must be managed to avoid conflict.

Competing Collateral Descriptions The collateral descriptions contained in financing documents should differ according to the specific type of loan. Collateral that is appropriate to support an operating line of credit is different from a floor plan. Collateral descriptions vary according to the purpose of financing:

1. Blanket liens. These are appropriate for use in operating lines of credit. The collateral description typical includes "all" inventory, equipment, office furniture, accounts receivable, chattel paper, general intangibles and any other property interest, including insurance proceeds, that a dealer may own during the life of the loan. The security provided is generally the value of a dealership's assets less the amounts subject to other financing such as purchase money security interests from floor plans or supplier financing.
2. Floor Plans. The collateral supporting floor plan loans should be limited to equipment actually being financed by the floor plan provider. All too often, however, floor plan providers will seek to include a blanket lien on all of a dealer's assets. Another common form of over-reaching is maintaining a security interest in paid inventory.
3. Supplier Financing. Many dealers overlook this type of financing, but the vast majority of dealer agreements include a security interest. This is perfectly appropriate where the supplier provides some financing like selling repair parts on "net 30" terms or granting "cash discounts" for wholegoods paid for within 30 days. Suppliers usually limit security interests to products the supplier provides. A conflict can arise, however, when the collateral description does not account for paid inventory or seeks to maintain a security interest in any product manufactured by the supplier even equipment obtained from another source such as trade-ins.

Avoiding Defaults The collateral description is like any other contract term – it can be negotiated between a dealer and the lender. Lenders generally do not want to put a dealer in a position of defaulting on another loan, because it puts the lender at a higher risk of non-payment. Lenders understand that their best chance of getting repaid is through continuing operations of the dealership and will work to avoid a default. Over-reaching lenders will not limit conflicts on their own, however, dealers must request changes. The first step is to compare loan documents and outline competing security interests. If there is an overlap in collateral, the dealer should talk to the lender who provided the new agreement to limit collateral to a commercially reasonable description. Suppliers and floor plan providers do not need blanket liens. Likewise, documents that prohibit a security interest in paid inventory may restrict a dealer's ability to draw on its line of credit. Collateral descriptions should match the purpose of the financing.

Subordination Agreements Another tool available to manage conflicting collateral descriptions is subordination agreements. These are prepared on a case-by-case basis and are usually agreements between finance providers as to the priority of the security interests. For instance, a supplier that prohibits security interests in the supplier's products even after they have been paid for may allow a competing security interest in paid inventory as to a specific lender, but not all lenders. Subordination agreements are not a one size fits all. There are a variety of types depending on the specific conflict to be resolved.

Conclusion Dealers need to be proactive to avoid inadvertent

events of default under the various financing documents that support a dealership. Every time a new dealer agreement, new floor plan agreement or new bank agreement is presented, a dealer should compare the collateral descriptions with other financing documents. If the same collateral is being used to support more than one loan, there is likely a problem that needs to be addressed by changing the collateral description. If a lender is unwilling to change the collateral description, then a subordination agreement may be considered. Barring some resolution of the conflict, the dealer may have no other choice than to switch to a different equipment supplier that offers commercially reasonable collateral descriptions.