

By **Stacie L. Chau**

## Fiduciary Responsibilities When Auctioning Property

Be careful what you bid for

**A**n increasingly popular option for fiduciaries to dispose of properties that are particularly difficult to maintain or sell is via an auction. Although auctions can yield successful outcomes, they can also be a pitfall for fiduciaries and a basis for claims of breach of fiduciary duties if the auction isn't handled properly, leading to less than desirable results.

### Why Auction?

The National Association of Realtors recommends adhering to the “two-thirds” rule: out of market, seller and property, if two of the three are suited for auction, then auctioning the property will likely achieve good results.<sup>1</sup> A good market for auction is typically: (1) either constantly changing or too dull, (2) currently lacking the specific property type (for example unique, like a lakefront), (3) emerging, or (4) one with high demand and a lot of competition. The seller best suited for auction is one who needs immediate cash, is moving out of the property quickly, wants to liquidate its assets and has high carrying costs. The ideal properties for auction are those with lots of equity (more than 25%), are unique enough to encourage competition among bidders, have high carrying costs for the owner and are currently vacant. Auctions work best when the seller is looking to attract a specific category of unique buyer.

### Pros and Cons

The pros and cons of disposing of property at auction are:



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Pros:

- **Seller controls terms controlled**—The seller controls the terms and timing of the auction, which can be advantageous to a fiduciary who needs to dispose of properties quickly due to liquidity or maintenance issues. It also allows the seller to structure the sale in a way that maximizes tax benefits—for example, doing an Internal Revenue Code Section 1031 exchange or selling the property to recognize a loss to offset capital gains in a taxable year. There's no need to negotiate terms with a buyer or risk the deal falling through if the parties don't come to an agreement.
- **Prequalified buyers**—The property is only exposed to vetted and prequalified buyers, allowing the seller to focus on serious buyers and reducing risks that a transaction will fall through due to a buyer's financing issues.
- **The property is sold as is**—The property is often sold as-is, with no home inspection or requests for repairs or credits, decreasing the possibility that a transaction will fall through due to inspection issues. This is particularly attractive for properties that have deferred maintenance issues, and the trust/estate lacks the liquidity to perform those repairs prior to a sale or is pressed for time.
- **Portfolio sale**—This permits the seller to list a large portfolio of properties at once, solicit bids and then determine how to sell each property in a way that maximizes financial benefit. If the fiduciary determines that certain properties in the portfolio have very low bids, it may decide not to proceed with the sale of those properties if its generated sufficient liquidity by auctioning other properties with better terms.



Cons:

- **Commission**—Auction companies generally charge commissions based on a percentage of the gross bid amount. The percentage is often higher than it is in a conventional sale. (In California, a conventional sale normally charges 4% to 5% commission, whereas an auction charges 5% to 8% commission).
- **Buyer’s premium**—Besides the auction commission charged to the seller, auction companies often charge the buyer a “buyer’s premium,” which is a percentage of the gross bid amount—often another 5%, which will cut into the amount the buyer is willing to offer for the property (as they’ll have to factor in the premium’s cost).
- **Marketing fees**—Depending on the terms of the auction contract, the seller may separately be responsible for marketing costs of the auction. This could be a flat fee charged to a third-party marketing company or an additional percentage fee of the gross bid amount. Often, the seller is responsible for the marketing fees even if the auction isn’t successful.
- **Marketing plan**—The marketing for auction properties needs to be tailored to specific audiences to be effective and worthwhile. Because the properties for auction are unique or have high carrying costs, the potential buyers for these properties are a targeted group. Mass marketing that isn’t tailored to an audience is a waste of the estate’s assets and will hinder the auction’s efforts and results, ending in detriment to the estate and exposing the fiduciary to liability.
- **Liability**—An agency relationship is created between the fiduciary and the auction company, potentially making the fiduciary liable for the auction companies’ actions, negligence or misconduct.

### Auctioneer/Fiduciary Relationship

Fiduciaries aren’t professionals in all areas of asset management and often rely on delegating specific tasks to third-party professionals. However, there’s a limit on what a fiduciary can reasonably delegate to a third party, and there’s an important degree of responsibility arising from the delegation. For

example, in California a “trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform” and “where a trustee has properly delegated a matter to an agent, cotrustee, or other person, the trustee has a *duty to exercise general supervision* over the person performing the delegated matter.”<sup>2</sup> Even when a fiduciary decides to retain an auction company and delegate the auction of the estate’s real property to that auction company, the fiduciary still has an obligation to supervise the auction company and can be held directly liable for failing to do so.

The auction contract creates an agency relationship between the auction company and the fiduciary, imposing potential liability. Fiduciaries aren’t automatically liable for the acts of their agents, but can be under certain circumstances. For example, in California, the Probate Code provides that trustees generally aren’t liable for the acts of their agents, except when the trustee: (1) directs the act of the agent; (2) delegates to the agent the authority to perform an act that the trustee is under a duty not to delegate; (3) doesn’t use reasonable prudence in the selection of the agent or the retention of the agent selected by the trustee; (4) doesn’t periodically review the agent’s overall performance and compliance with the terms of the delegation; (5) conceals the act of the agent; or (6) neglects to take reasonable steps to compel the agent to redress the wrong in a case in which the trustee knows of the agent’s acts or omissions.<sup>3</sup>

Therefore, a California fiduciary can be held liable for the acts of the auction company when it fails to: periodically review the auction company’s performance, use reasonable prudence when selecting the auction company or adequately supervise the auction company’s actions. Ultimately, the fiduciary owes its duties to the trust/estate and its beneficiaries and must ensure that the auction company carries out its duties in a way that will also benefit the trust.

The fiduciary should watch out for any breaches by the auction company that may damage the trust/estate, as they may potentially open the fiduciary to liability for breach of fiduciary duty under an agency theory. For example, if the auction company fraudulently misrepresents information about the property to prospective buyers, then the fiduciary



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may be held liable for that misconduct if they failed to adequately supervise the auction company or failed to conduct reasonable due diligence when hiring the auction company.

### Fiduciary Checklist

There are several countermeasures the fiduciary can take to protect itself when auctioning a property and reduce risk of liability for breaching its fiduciary duties.

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The fiduciary should always consult the relevant governing estate-planning instrument and ensure that there are no restrictions attached to the property that would preclude its sale by auction.

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**Confirm the property is suitable for auction.** The fiduciary should always consult the relevant governing estate-planning instrument and ensure that there are no restrictions attached to the property that would preclude its sale by auction. Further, when deciding whether to sell the property via auction, the fiduciary must make sure that it's complying with the relevant jurisdiction's Prudent Investor Act (PIA).<sup>4</sup> Even if the trust instrument states that the property can't be sold, the fiduciary may have a duty to dispose of it under the PIA. For example, if a large trust consists solely of extremely unique real properties with high maintenance costs and the trust has low liquidity, the duty to diversify may require the fiduciary to diversify the investment and sell a portion of the portfolio to be invested in other investments to diversify the risks. In such a case, the fiduciary may want to petition the court for instructions granting an order to sell or auction the property, even if the trust instrument doesn't allow

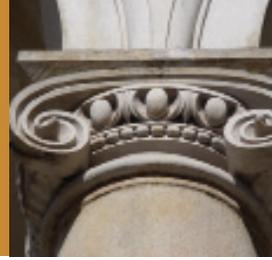
the disposition of the real properties.<sup>5</sup>

**Document every stage of the process.** From choosing the auction company, to negotiating the listing agreement, creating the marketing plan and drafting the auction sale documents—the information obtained and the fiduciary's rationale behind each decision should be carefully documented. If litigation arises, this documentation will be valuable evidence that the fiduciary performed the necessary due diligence and, given the information known to the fiduciary at that time, performed accordingly.

**Research auction companies and make careful selection.** The fiduciary should solicit proposals from various reputable auction companies and compare them. For example, the fiduciary should investigate whether the auction company has: (1) experience and expertise to auction the type of property at issue; (2) experience and expertise in the local market; (3) a marketing platform and resources to market the property; (4) a reasonable charge for fees and commissions; (5) information on a closing ratio and price; and (6) references and number of repeat customers. Performing this due diligence is essential in limiting the fiduciary's liability for selecting and delegating the sale to the auction company.

**Ensure a targeted and effective marketing strategy.** The fiduciary should carefully work with the auction company and approve a marketing plan that's comprehensive and sufficiently tailored to the targeted audience, with an eye on the fees associated with it. The marketing plan should cover a time period long enough to attract all prospective buyers but should be short enough to prompt the buyers to bid quickly. The price of the starting bid, or the reserve, should be low enough to encourage multiple bids and a potential bidding war, but not too low that it wouldn't solicit fruitful bids.

**Assemble due diligence/disclosure packets for potential bidders.** The fiduciary can reduce the risk of liability by working with the auction company and an attorney to assemble a comprehensive due diligence packet for all prospective buyers. The packet should make disclosures (in compliance with the law in the applicable jurisdiction) regarding the condition of the property and any defects, making the auction process fully transparent. Doing so



will lessen the danger of the buyer later suing the auction company or the seller for failure to disclose certain issues with the property or making misrepresentations.

**Get a lawyer involved.** An auction company, however experienced with auctions, typically doesn't have the requisite legal knowledge regarding the heightened scrutiny and liability a fiduciary faces when auctioning a property on behalf of a trust/estate. That's where a lawyer comes in. A fiduciary should always get a lawyer involved in the auction process to review all agreements, point out areas of due diligence for the fiduciary and advise on a course of action that will diminish liability. For example, in the face of contentious beneficiaries or ambiguous trust language, an attorney may advise the fiduciary to petition the court for instructions and obtain an order instructing the fiduciary to proceed with an auction or certain terms of an auction.

The laws governing auctions, real property transactions and fiduciary responsibilities also differ across jurisdictions. It's important to have an attorney to make sure the fiduciary and auction company are acting in compliance with all applicable laws to avoid any future claims by the buyers or the beneficiaries. For example, in California, the sale of real property by a trust can be exempt from traditional seller disclosure requirements.<sup>6</sup> Failing to use the appropriate disclosure form could be basis for a claim of breach against the fiduciary.

**Tricky clauses in action agreements.** The lawyer should draft an auction contract or carefully review a draft of an auction contract provided by the auction company. Some auction contracts provide that if the auction property is sold within a certain amount of days (usually 120) of the auction date, even if it's not sold to a buyer via auction, the seller is responsible to pay the auction company a buyer's premium on behalf of the buyer. This is a tricky clause and premised on the argument that the non-auction buyer was a result of the auction company's marketing efforts, thus the auction company is still entitled to a buyer's premium. This clause should be carefully considered and preferably revised to ensure that the auction company doesn't benefit if the non-auction buyer didn't purchase the property due to the auction company's marketing efforts. The

auction contract should also clearly address whether the seller is responsible for costs, such as marketing fees, even if the property fails to sell.

**The purchase and sale agreement.** Similarly, the lawyer should draft or carefully review a draft of the sale contract with the buyer after a successful bidder has been selected. For example, the contract should address: contingency periods and removal, whether the sale is subject to court confirmation, whether fixtures or personal property items/furnishings for the property are to be included or excluded, whether there should be liquidated damages and whether to include arbitration or mediation clauses in the event of breach or dispute.

**Be personally present during auction and necessary decisions.** The fiduciary should involve itself in each step of the auction process and, if at all possible, be personally present at the auction to show its involvement (no matter what format the sale takes place—if electronic, the fiduciary should still be monitoring it virtually).

### Most Common Claims

The most common claims for breach against a fiduciary relating to an auction of real property are: (1) the property shouldn't have been auctioned; (2) the marketing for the auction was poorly conducted and didn't expose the property to qualified bidders, resulting in undesirable outcomes; or (3) the terms of the auction agreement or purchase and sale agreement weren't favorable. When considering an auction, the fiduciary should always keep these points in mind, take any actions necessary to investigate the options at hand and document all analyses and resulting decisions. 

### Endnotes

1. See [www.nar.realtor/auctions/what-properties-are-suited-for-auction](http://www.nar.realtor/auctions/what-properties-are-suited-for-auction) for more information.
2. California Probate Code Section 16012, subdivision (a) (emphasis added).
3. California Probate Code Section 16401.
4. For example, in California, the Prudent Investor Act is codified at California Probate Code Sections 16045-16054.
5. California Probate Code Section 17200.
6. California Civil Code Section 1102.2, subdivision (d).