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Considerations for Appraisers in Regard to Dummy Auction Bids

by Richard Reed

When called upon to investigate the circumstances surrounding a sale, appraisers have typically welcomed an auction as an arm's-length, open-market sale and a viable way to successfully complete real estate exchanges. The definition of the market value of real property remains the focus of all real estate appraisal reports and can be stated as "the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion." The auction process overcomes many of the problems that can be associated with this definition of market value. For example, a typical marketing period prior to an auction is approximately four weeks. Coupled with an advertising campaign and "open for inspection" time, this is normally considered an adequate length of exposure for most residential properties.

As long as the auction is well attended by the purchaser public, the final sale price is supposedly set by the market and not by the vendor. Or is it? In other words, the use of an auction sale has commonly been seen to overcome many of the problems associated with vendors' lack of knowledge about the marketplace. For example, a vendor would rarely inspect other properties for sale in the prevailing market with the same level of detail that a purchaser would. Therefore, if conducted and marketed properly, an auction protects the interests of the vendor in accordance with the definition of market value. However, little consideration has been given to the conduct of auctions from the purchaser's perspective, and to whether the auction really results in an arm's-length, open-market sale.

Unfortunately the practice of dummy bids has resurfaced in Melbourne, Australia, with little evidence to suggest that it ever disappeared completely. Dummy bidding (also referred to as "vendor bidding") has been part of the

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Melbourne real estate scene for 30 years. This technique could cause the purchaser to pay an amount over and above the true market value for the property, at times competing with a bidder who is acting on behalf of the auctioneer or vendor and has no intention of actually buying the property.

**Background**

The residential real estate market in Melbourne, Australia, is commonly referred to as the auction capital of Australia, if not the world. It has been estimated that approximately 75% of residential properties in Melbourne are sold by a planned auction program, including a successful offer prior to, during, and after the auction date. The balance of residential real estate is sold by private treaty, i.e., a private sale with the assistance of a real estate agent, using a for sale price or by a tender process, whereby a property is placed on the market for sale and a closing time/date is advertised. The highest bidder for the property (the highest tender) is able to purchase the property for the amount bid. It is generally accepted in the marketplace that most houses are sold by auction, and the purchaser marks is well trained to attend advertised open house inspections within the standard, four-week marketing period. Buyers gather outside the property just before the publicized time and then listen to the auctioneer state the rights of the auctioneer. Notably the auctioneer reserves the right to include or exclude any bids, and to sell the property only if the price is agreeable to the vendor and also reaches or approaches the reserve, i.e., the seller’s asking price.

The reserve price, which is set by the vendor, is central to the efforts of the auctioneer to reach the highest price and facilitate a successful sale. Unless the bids reach the reserve price, the property is unlikely to be sold. The reserve may be set at a level higher than the market value, thereby creating pressure on the auction process to achieve high bids even before the auction commences. Furthermore, the reserve price itself can fluctuate according to the state of the residential market and its position in the real estate cycle. For example, when the reserve price is harder to achieve because of a downswing scenario, there is a greater temptation to use a dummy bidder to reach the reserve price. Some forecasters are suggesting that a downswing in the residential real estate market may be imminent, and the use of dummy bidders may support this view. Clearly, in a market upswing the tactic of dummy bidding is not required because genuine buyers actively compete with each other during the auction, without prompting. The skill of the auctioneer to increase the amount of the bids is clearly evident at most auctions, ranging from talking up the bidders with a raised voice to constant retreats into the house for supposed vendor discussions. All are accepted tactics used by the auctioneer in an effort to increase purchaser bids, and all purchasers are fully aware of and anticipate such antics.

Even though there may be remedies under the Trade Practices and Fair Trading Acts for misrepresentation and misleading and deceptive conduct, actually proving that dummy bids are in breach of the Acts may be difficult. The courts, however, have ruled that a contract implies terms that a party should act reasonably, fairly, and in accordance with due process. For example, in the case of Hughes Aircraft Systems International v Air Services Australia, the Federal Court decided that in a tender process a contract arose between the organization seeking tender offers and those making them, and that the parties to that contract should act reasonably, fairly, and in accordance with due process. Similarities can be drawn between this case and the relationship between the auctioneer and the highest bidder. This relationship may give rise to a contract, and it is an implied term of this contract that the parties would act reasonably, fairly, and in accordance with due process. Obviously, the use of a dummy bidder breaches this term.

**Review of Literature**

As anticipated, a global literature search revealed that little or no research has been conducted on the ef-

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ffect of dummy bidding on final sale prices, obviously due to the difficulties associated with defining and measuring the effects of this secretive but accepted practice. However, researchers have studied the auction process and differences between the final sale price of an auction sale and that of a private, open-market sale, which produced interesting results for both techniques.

The overall trend in the research indicates that an auction of a residential property would produce a higher transfer price than if a conventional, open market, private sale process were used. Previous studies conducted in Australia suggest that auction sales carry a premium of approximately 3% and can be as high as 15%. A Melbourne study using house sales data from 1988 and 1989 concluded that a vendor would achieve an additional 5.5% in sale price by auctioning.

However, no valid reasons were offered to explain this premium. According to Lush, “while differences in market conditions can explain variations in the auction discount, they cannot explain why auctioned property should ever sell at a premium.” While an auction conducted under “must sell” circumstances (e.g., mortgagee in possession) would place downward pressure on the final sale price, a higher sale price produced by an auction requires additional analysis. It has been argued that an auction benefits the real estate industry, and the buyer at an auction is placed at a clear disadvantage in an auction process, with seemingly little control over the auction proceedings and the bidding process. This may be true in some respects and could encourage the use of tactics such as dummy bidding to inflate the price. Seemingly impossible to measure, the extent of dummy bidding at auctions is perhaps more prevalent than estimated.

**Dummy Bids in the Auction Process**

Regarded as a known practice in some residential auctions, the use of a dummy bidder has received increasing attention in recent times. Employing this tactic can have an adverse effect on the mechanics of the auction process and on the final sale price. This technique may involve the prior agreement of a bidder who is a trusted friend or associate of either the vendor or the auctioneer. During the auction, this person is actively involved in the bidding process, and the auctioneer accepts his or her false bids as a genuine effort to successfully purchase the property. The dummy bidder, however, has no intention whatsoever of actually buying the property, fully intending to withdraw from the bidding process before the final bid is given. Even so, if the dummy bidder is unexpectedly the last bidder, the auctioneer has the publicized right not to accept that bid and can take the bid from the second-highest bidder. For example, a genuine purchaser may bid $298,000 for a particular property. The next bid of $299,000 is then given by the dummy bidder with the sole intention of enticing the genuine purchaser to bid again at $300,000. However, the genuine bidder refuses to bid higher, and the dummy bidder is caught out with the highest bid. At this point, the auctioneer reserves the right not to accept the highest (and false) bid, and to return to the second highest bid, that of the genuine purchaser.

Overall there are three main tactics employed by a dummy bidder: commencing the bidding at a high level, actively competing in the bidding process to reach the reserve price, and actively competing in the bidding process to reach the highest price after meeting the reserve price.

1. **Commencing the Bidding at a High Level**

It is common knowledge that a group of purchasers will tire if the opening bid is too low, as prices tend to increase as the auction progresses. If relatively small monetary increments are used (as dictated by the purchasers, where the auctioneer is reluctant to

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8. Dotzour et al., *ibid*.
11. Dotzour et al., *ibid*.
discard any bid), it may take too long for the bidders to reach the reserve price. In each purchaser’s mind remains the thought that someone viewed this property as worth only a low amount (i.e., the opening bid). To avoid this, the dummy bidder commences with a high bid, one positioned just below the reserve. This gives the false impression that the property is worth more rather than less and gets the bidding process off to a competitive start. In other words, the market perceives that there is a higher level of demand for the property (as reflected in the commencing bids) than there really is. As purchasers often follow a herd mentality, the higher opening bid is often disregarded, and bidding continues at an inflated level towards an overall inflated final transaction price.

2. Actively Competing in the Bidding Process to Reach the Reserve Price

Unless the bidding reaches the reserve price set by the vendor, the house will probably not sell at the auction. Therefore, the dummy bidder has a set monetary amount to bid up to, but not to exceed. This tactic is successfully employed if there is only one serious bidder at the auction, who would be unwise to bid against his or her own bid. The dummy bidder will push the serious purchaser up to the reserve price and then withdraw. If there is no serious competition and the reserve price is not achieved, the auctioneer declares the highest bid that did not reach the reserve price, and the property remains unsold. Then the dummy bidder has the first right of refusal, although the target purchasers for sellers in this example would be the second-highest bidder.

The salespeople from the real estate agents often then speak to all the bidders individually at the end of the auction, including the genuine bidder who reneges at the last moment before the property reaches the reserve price. The difficulty for real estate appraisers arises when determining the willing buyers in the marketplace, as opposed to dummy bidders who are artificially inflating the price and conspiring against the genuine bidder. It is this level of deceit and misrepresentation that adversely affects the auction process. Each real estate appraiser must determine if the final sale price closely resembles market value, especially with the regard to the purchaser’s ability to act “knowledgeably, prudently, and without compulsion.” A purchaser’s level of knowledge about competing purchasers is seriously challenged by the active participation of a dummy bidder.

3. Actively Competing in the Bidding Process to Reach the Highest Price After Meeting the Reserve Price

It is only the highly experienced dummy bidders who are able to master this skill and not end up making the bid too high. The goal is for the genuine bidder to have the highest and last bid, pushed all the way by the dummy bidder who withdraws with the second-to-the-last live bid.

These three techniques are the most common employed by dummy bidders. The auction process protects their identity because only the final, successful bidder is required to disclose his or her name. The dummy bidder can simply melt into the crowd, having created the perception of a false market for the property.

The Effect of Dummy Bidding on Market Value

There is little doubt that the general definition of market value, with the emphasis placed on the measure of eager, willing buyer and eager, willing seller in the relationship, would be adversely affected by the use of a dummy bidder. Figure 1 clearly shows the effect that a dummy bidder could have on falsely inflating the price of a property. The true market value should be recorded at point (A), where the property buyer and seller are fully aware of all the circumstances surrounding the sale, including the true state of the market and the actual demand for the property. However, the use of one or more dummy bidders deceptively increases the number of buyers in the marketplace, as indicated by (B). This false market now creates more demand and a higher price for the property, which at times is substantially above the true market value as shown by (C). In many instances, a final, successful bidder could have been competing with a dummy bidder and would not have bid as high if the dummy bidder had not participated in the auction. The end result would be a variation between the agreed sale price at the auction and the true market value of the property.

Suggested Amendments to the Auction Process

There are a number of steps that could be taken to remove the deceit caused by dummy bids. Although these suggestions would address some of the problems associated with this practice, the enforcement of them may prove to be difficult.

13. Sherman et al., Ibid.
**Figure 1** Effect of Dummy Bids on the Auction Process

![Diagram showing the effect of dummy bids on the auction process.]

**Suggestion 1**
The auctioneer, vendor, and other parties with a financial interest in the sale must declare their relationship with any parties attending the auction. This would ensure that the bidders are true, arm's-length purchasers and do not have hidden interests in the auction process.

**Suggestion 2**
The legal framework surrounding auctions requires urgent attention to ensure that this form of deceit is not continued. Legislation should be enacted using a range of tough fines—including loss of auctioneer's license—for the proven use of dummy bidders in an auction.

**Suggestion 3**
The relevant industry associations (e.g., Real Estate Institute of Australia) should actively support the eradication of dummy bidders from auctions by inclusion of the prohibition of this practice in their codes of ethics and enforcement thereof. For example, members found to have violated their association's code of ethics should be publicly named and heavily fined individually, with a similar action taken against the real estate organization within which they are employed.

**Conclusion**
Auctions have always been promoted as a tried and proven method of achieving the highest sale price for a property. An auction gathers together prospective purchasers in one place at one time and sells the property to the highest bidder. It has been proven in empirical research that auctions generally achieve a higher final sale price than a private, open market sale. Even though both of these approaches to selling real property are applied in the same marketplace in accordance with the definition of “market value,” there have been no valid reasons to explain this difference in price. One practice that has been openly acknowledged is the practice of dummy bidders, which may partly explain this premium. The use of dummy bids by the vendor and/or the auctioneer could have the effect of distorting the true market value and is designed to deceive the purchasing public into competing at an inflated price in the auction process. Clearly the ideal solution to combat this problem would be for real estate appraisers to discard all distorted sales, although in practice this task is not simple. Properties that were sold at auctions that involved dummy bidders are practically impossible to identify unless the true intentions of all bidders at that particular auction are fully disclosed. This would be a mammoth task.

It appears that the genuine popularity and reputation of the auction process is seriously threatened by the deceitful use of dummy bidders. Steps must be taken to eradicate the tactic before the entire residential auction industry is discredited, and a 'level playing field' must be returned for the vendor, auctioneers, and bidders alike. Potential improvements to the auction industry to discourage this practice could include strong fines to both the individual auctioneer and his or her employer, with endorsement of the fines by the relevant industry body. Not until
the successful eradication of the dummy bid and associated deceitful practices (e.g., ‘two tier’ marketing) will purchasers and vendors be able to trade confidently in a fair and equitable marketplace. Only then will appraisers be able to rely confidently on sale price as indicative of true market value.

References


Richard Reed is a lecturer in property investment at the University of Melbourne and has conducted research in a diverse range of property-related topics including housing markets, the appraisal industry, and property as an investment medium.
His PhD focused upon the relationship between demographic influences and property values.

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