

# PUBLICATION

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## Titled Vehicles: Roll Through UCC Provisions Carefully and Watch Out for Speed Traps

November 1, 2012

Prudent lenders active in the financing of motor vehicles understand the intricacies that result from the interplay between the Uniform Commercial Code (the “UCC”) and state Certificate of Title Acts. This edition of *Dispatches from the Trenches* addresses a few key areas where overlapping provisions can complicate matters. It also provides a couple of notable statutory and case law updates.

### 1. Proper Method of Perfection—Watch out for Idaho, Illinois, Louisiana and Rhode Island

Those familiar with the financing of titled equipment are used to perfecting their interest in the vehicles by notation of a lien on the certificate of title—the proper method of perfection under state Certificate of Title laws. The drafters of Article 9 of the UCC understood the detailed system already in place on a state level for recording ownership interests and liens on titled equipment. In light of this existing recording system, the UCC provides that “the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to . . . a certificate-of-title statute covering automobiles, trailers, manufactured homes, boats, farm tractors, or the like, which provides for a security interest to be indicated on the certificate as a condition or result of perfection . . . .”<sup>[1]</sup>

However, there is a notable exception to this rule. In order to facilitate the ability of lenders to “floor plan” or otherwise finance the acquisition of inventory by dealers of titled equipment, the UCC in **almost all States** provides that filing a financing statement is the proper method of perfection “[d]uring any period in which collateral subject to a [state Certificate of Title law] is **inventory** held for sale or lease by a person or leased by that person as lessor and that person **is in the business of selling goods**.”<sup>[2]</sup>

Unfortunately, early drafts of the most recently enacted version of this exclusion included language applying this exception even if the borrower was in the business only of **leasing** the goods—in other words, that version of 9-311(d) required a lender to perfect by filing a UCC “[d]uring any period in which collateral subject to a [state Certificate of Title law] is inventory held for sale or lease by a person or leased by that person as lessor and that person **is in the business of selling or leasing goods**.” This broader “selling or leasing exception” was originally enacted in Idaho, Illinois, Louisiana, Rhode Island and Missouri.

The above quoted provisions have two primary elements. First, the vehicles must be “inventory.” Second, the borrower must be in the business of selling goods of that kind in most states (or selling *or leasing* goods of that kind in the handful of states with the incorrect version of this UCC provision). Whenever vehicles are leased by a borrower to one or more third parties, the vehicles become “inventory” under the UCC.<sup>[3]</sup> This inventory classification is fairly common in the highly regulated over-the-road-trucking industry where parties “lease on” to carriers or otherwise utilize lease structures to obtain the benefit of certain operating licenses and otherwise comply with certain legal requirements. Some companies also utilize a corporate structure pursuant to which a separate equipment holding company owns vehicles, due to the increased liability risks, and leases them to affiliates.

The net result is that, in all fifty states, a Lender must perfect by traditional UCC filing processes if the borrower is in the business of **selling** goods of the type being financed (even if the specific goods financed are being held solely for lease).

### ***A. Idaho, Illinois, Louisiana and Rhode Island***

As of October 2012, Idaho, Illinois, Louisiana and Rhode Island still have the non-uniform problematic language. The net result is that prudent financiers with a lien on titled equipment that is leased by the borrower to third parties should perfect by noting their lien on the certificate of title **and** through the traditional UCC filing processes in the event that either: (1) the debtor is located (for article 9 purposes) in one of these four non-uniform states; or (2) the applicable Certificate of Title is issued in one of these four states. This recommendation stems from the uncertainty as to how the mandatory choice of law provisions in Sections 9-301 and 9-303 of the UCC would be applied in light of the non-uniform versions of 9-311(d). In addition, anyone relying on purchase money priority should be mindful of the additional steps under the UCC necessary to have such priority in "inventory".

### ***B. Missouri***

Effective as of August 28, 2012, Missouri has amended its statute to be consistent with the standard UCC provision and has deleted the "or leasing" language from the applicable UCC exception.<sup>[4]</sup>

A theoretical issue remains as to the effectiveness of actions taken prior to that date. If, prior to August 28, 2012, an existing Lender perfected by filing a UCC-1 Financing Statement covering all titled vehicles leased by a borrower who was in the business of leasing (but not selling) goods of that kind, does the change of law render that financing statement ineffective with respect to those titled vehicles? Would a new Lender seeking to finance those vehicles after August 28, 2012 be able to rely solely on the Certificate of Title or must it seek a release from the existing Lender to assure itself of a first priority interest? To date, there is no case law addressing this issue.

Since the Missouri statutes were arguably changed solely to correct a glitch which rendered the statute inconsistent with the official version, it does not appear much thought was given to the effect of the sudden change of law. The lack of statutory attention to this issue is in stark contrast to the formal transition rules set forth in Part 7 (Transition) when Article 9 was revised early last decade to keep "old filings" effective for a period to time.

## **2. Sale out of Trust - Impacts of Certificate of Title Laws.**

In addition to the perfection issues discussed above, financing titled vehicles for borrowers who are in the business of selling or leasing them to third parties raises other issues.<sup>[5]</sup> If the borrower is in the business of selling goods of that kind, statutory language in the UCC grants it the power (even if not the contractual right) to convey title free and clear of security interests. Article 9 of the UCC provides enhanced rights to certain parties who purchase inventory, stating: "a buyer in ordinary course of business. . . takes free of a security interest created by the buyer's seller, even if security interest is perfected and the buyer knows of its existence."<sup>[6]</sup>

This rule is used to invalidate a perfected security interest in a borrower's inventory when that inventory is sold in a manner that "comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices."<sup>[7]</sup> The idea is that inventory lenders expect for borrowers to sell inventory to make profits and that this rule does not adversely impact the inventory lender since the lender's interest in the inventory is not cut off by Section 9-320 until the goods are actually sold by

the borrower and since the Lender's security interest will continue in identifiable proceeds generated by the sale.<sup>[8]</sup> The rule also encourages the marketability of goods and protects the interest of buyers who assume that they have clear title to goods they purchase from vendors in the business of selling goods of that kind.<sup>[9]</sup> Other provisions in the UCC create similar results.<sup>[10]</sup>

A "buyer in ordinary course" is defined be someone "that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person . . . in the business of selling goods of that kind."<sup>[11]</sup> It is a term limited almost exclusively to buyers out of Inventory.<sup>[12]</sup>

Once again, the interplay between the generally uniform provisions of the UCC and the various state Certificate of Title laws can create mixed results. Consider, for example, the recent case of *La Gar Marketing, Inc. v. Western Finance & Lease, Inc.* <sup>[13]</sup> where a lender ("Lender") financed the acquisition of a vehicle by a borrower that was a motor vehicle dealer. That borrower sold the financed vehicle on credit to a third party ("Purchaser") in violation of the financing documents with Lender. After borrower defaulted on its obligations to Lender, Lender repossessed and sold the vehicle. Purchaser, who had paid the majority of the purchase price but never received the certificate of title for the vehicle, sued Lender seeking a declaratory judgment that it had superior title as well as damages for conversion.

The Court noted that the "[t]he ultimate issue in this case is whether the provisions of Article 9 of the Uniform Commercial Code (UCC) that protects buyers in the ordinary course prevail over the certificate of title requirement in [the Ohio Certificate of Title Act]."<sup>[14]</sup> The applicable provision in the Certificate of Title Act stated that:

No person acquiring a motor vehicle from its owner, whether the owner is a manufacturer, importer, dealer, or any other person, shall acquire any right, title, claim, or interest in or to the motor vehicle until there is issued to the person a certificate of title to the motor vehicle, or there is delivered to the person a manufacturer's or importer's certificate for it, or a certificate of title to it is assigned as authorized by [this Act]. . . . and no waiver or estoppel operates in favor of such person against a person having possession of the certificate of title to, or manufacturer's or importer's certificate for, the motor vehicle, for a valuable consideration.<sup>[15]</sup>

The Court found the legislative intent of this language to be crystal clear and held that, however unfair it may seem to a buyer in ordinary course, the Certificate of Title Act controlled. As such, Purchase never acquired title to the vehicle and summary judgment was awarded to Lender.

Lenders are not always so lucky, whoever. Consider, for example, the Alabama case of *Jones v. Mitchell*,<sup>[16]</sup> where the Court held that the Alabama Uniform Certificate of Title and Antitheft Act did not preclude buyer in ordinary course of business status under the UCC from applying to the purchaser of a vehicle from a used car dealer since, doing so, "would be extremely onerous to the consumer and would substantially impede commercial transactions."<sup>[17]</sup>

There are two key take-aways from this issue of Dispatches. First, titled vehicles receive special treatment under the UCC (a later issue of Dispatches will discuss special accommodations made in the UCC with respect to accessions to motor vehicles). Second, attempts to sync Certificate of Title Acts with the UCC sometimes yields non-uniform results. Lenders financing motor vehicles should move through UCC provisions carefully and watch out for what could be viewed as poorly marked road signs, or worse, actual speed traps.

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<sup>[1]</sup> UCC § 9-311(a)(2).

[2] UCC §9-311(d).

[3] UCC §9-102(a)(48) (Goods are “inventory” if they are “leased by a person as lessor [or] held by a person for sale or lease or to be furnished under a contract of service [or] are furnished under a contract of service.” )

[4] See Missouri, S.B. No. 485 and Missouri Revised Statutes, §400-009.311(d).

[5] With respect to those in the business of leasing goods of that kind, UCC §9-321(c) provides that “[a] lessee in ordinary course of business takes its leasehold interest free of a security interest in the goods created by the lessor[/Debtor], even if the security interest is perfected and the lessee knows of its existence.”<sup>[5]</sup> This right of the lessee is commonly referred to as a right of quiet enjoyment. Even if the Lender has a security interest in the underlying equipment, it will not be able to repossess the equipment from the lessee so long as the lessee is current on its obligations under the lease unless the lease documents provide otherwise.

[6] Revised Article 9-320 (paralleling Former Article 9-307).

[7] Article 1-201(9).

[8] Of course Inventory lenders also often take a security interest in accounts generated by the sale of the Inventory rather than merely relying on the proceeds rules of Article 9 of the UCC.

[9] Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, Vol. 1, ¶3.04(1).

[10] See e.g. the Entrustment Provisions in UCC §2-403.

[11] Article 1-201(9).

[12] Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, Vol. 1, ¶3.04(1).

[13] 2012 WL 4898785 (Ohio App. 9. Dist. 2012)

[14] *Id.* at \*3.

[15] Ohio Revised Statutes, §4505.04.

[16] 816 So. 2d 68 (Civ. App. 2001).

[17] *Id.* at 71.