Moritt Hock Hamroff & Horowitz LLP
ATTORNEYS AT LAW

STRENGTH IN PARTNERSHIP

ALERT

October 2009

WHEN ACQUIRING A SECURITY INTEREST IN VEHICLES BY WAY OF ASSIGNMENT, GOOD & SAFE PRACTICE MAY DICTATE DENOTING ASSIGNMENT ON CERTIFICATE OF TITLE

While a recent Texas decision may currently be the only decision of its type in the country (and the impact of the decision has been addressed by recent legislative action in Texas) for vehicle lessors and financers, it is certainly worth a second look. It is not uncommon in the motor vehicle industry for many vehicle financers to acquire an interest in vehicles and the related security documents by way of assignment. When first documenting a financing transaction for a vehicle, in addition to whatever lease financing documents may be signed, the financer in question will usually ensure that they procure a certificate of title which contains a notation that the lender maintains a security interest in the particular vehicle. The purpose of this practice is to ensure that any third party has notice of such lien and, in the event of an attempted sale, any purchaser is aware of the interest of the lender in any proceeds as well as the vehicle in question.

Further, it is not uncommon in the event that the underlying financing package is assigned, for the assignment to be effectuated simply by a single agreement assigning the loan package without any attempt to modify the existing certificate of title (or original documentation.) While the independent assignment agreement is sufficient for transferring the financial obligations created under the original financing package, it may be insufficient to cover "protection" of the lien priority in that package as against third parties. The recent decision of a Bankruptcy Court in Texas in the case of, *In re Clark Contracting Services, Inc.*, 399 B.R. 789 (Bankr. W.D. Tex. 2008) finds that the failure of an assignee to take steps to ensure that the certificate of title reflected the name of the new lender rendered the assignee's lien unperfected.

In the *Clark* case, Clark had financed its acquisition of construction equipment from CIT Group/Equipment Financing ("CIT".) The financing package included a Promissory Note for each piece of equipment, a Master Security Agreement and original Certificate of Title for each vehicle. A UCC Financing Statement was also filed reflecting CIT's lien in the equipment. Thereafter, Wells Fargo Equipment ("Wells") purchased the financing package from CIT prior to Clark filing for bankruptcy. At this time, Wells elected not to obtain new certificates of title, but simply relied on the existing ones reflecting CIT as the lien holder. Clark commenced an adversary proceeding seeking to determine that the lien of Wells was unperfected and could be avoided under 11 U.S.C. § 544(b). (This Section of the Bankruptcy Code allows the debtor to use what are known as "strong arm powers" and stand in the "shoes" of a judgment lien creditor to avoid unperfected liens in assets.)

The Bankruptcy Court agreed with Clark and found that the failure of Wells to secure a new Certificate of Title denoting its lien on the Certificate of Title left Wells unperfected in the underlying vehicles. The Bankruptcy Court predicated its decision

on an analysis of the interplay between the Uniform Commercial Code ("UCC") and the Texas Certificate of Title Act ("COTA".) In rendering this decision, the Court found that while the UCC did not mandate that the assignee of a financing transaction file an amended UCC reflecting a change in the lienor, the COTA was more restrictive and contained such a requirement. (Since any third party looking to ascertain if a lien existed they would look to the Certificate of Title, the Bankruptcy Court determined that the reliance on COTA for a determination of perfection was appropriate.) The Bankruptcy Court also found that the UCC and COTA did not conflict; rather the Bankruptcy Court found that the COTA, and not the UCC sections, on continued perfection in the event of assignment, governed the final analysis of the Complaint at hand. Perhaps most importantly, the Court pointed out that in order to secure continued perfection and gain the benefit of a "relation back" to the original filing date, a separate section of the COTA specifically required that an assignee had to follow those filing provisions, which specifically require obtaining a new certificate of title. COTA Sec. 501.114. This section was determined to trump any other debate about whether obtaining a new certificate is required if the question is one of the date of perfection. (This would be the case in the event of a challenge by a lien creditor.)

The Bankruptcy Court found that the COTA (as opposed to the UCC) was intended to, among other things, provide notice to third parties and under the COTA such parties were entitled to rely on what appears on the certificate of title and look no further. In so finding, the Bankruptcy Court overruled a variety of arguments interposed by Wells including: (i) the contention that the COTA did not expressly require a new certificate of title to be procured when an interest in a vehicle is assigned as assignment does not affect perfection; (ii) the fact that while Section 501.114 of the COTA states that "an assignee may apply for a new title", the Section was permissive in nature not mandatory; and (iii) that the provisions of the UCC should control as the provisions of the Texas COTA and UCC conflict on this point. Among these contentions there are some good arguments that would or could be used to argue against the result in this case and future cases.

The remarkable part is that both the UCC and COTA sections which related to the perfection of liens, rely upon the concept that the purpose of perfection is to give notice to third parties that there is a lien on the vehicle in question. The Texas decision seems to lead to a further requirement that it is not just notice of fact that there is a lien but exact notice of who the lien holder is at the present time. Oddly, the Texas Department of Motor Vehicles is not a searchable database, so the only way to know if there is a lien is to actually see the certificate of title. Regardless, the question in the case was one of proper perfection so these questions were not particularly germane.

Subsequent to the issuance of this decision, industry leaders and associations responded quickly to the ruling by submitting legislation to the Texas Legislature to clarify and confirm that Texas law does not require re-titling of certificates of title to effectuate the assignment of a lien or to continue perfection of an assigned lien in the assignee's assets. In addition, Wells Fargo has indicated that it intends to appeal the *Clark* decision. We will provide an update to this Alert when, and if, a decision in the appeal is issued.

This Alert was written by Leslie A. Berkoff and Michael Cardello III. Ms. Berkoff, a partner with the firm, serves as co-chair of the firm's litigation and bankruptcy practice groups where she represents a variety of corporate debtors, trustees, creditors and creditor committees both nationally and locally. Mr. Cardello, a partner with the firm, concentrates his practice in commercial litigation and bankruptcy and represents clients in the vehicle leasing industry.

Any questions concerning the matters raised in this Alert should be addressed to either Ms. Berkoff or Mr. Cardello. They can be reached at (516) 873-2000 or by email at lberkoff@moritthock.com or mcardello@moritthock.com.