Articles

"Clark Contracting: Texas Lien Assignees Unperfected?"

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A recent decision of the United States Bankruptcy Court for the Western District of Texas, San Antonio Division jeopardizes the collateral of companies engaged in financing Texas automobiles and other assets subject to various Texas certificate of title statutes. The bankruptcy court in *Clark Contracting Services, Inc. v. Wells Fargo Equipment Finance (In re Clark Contracting Services, Inc.)*; Adv. No. 08-5045-LMC granted a partial summary judgment in favor of Clark Contracting Services, Inc. ("Clark"), a Chapter 11 debtor-in-possession, finding that Wells Fargo Equipment Finance ("Wells Fargo") did not have a properly perfected security interest in six motor vehicles owned by Clark. The court held that Wells Fargo, which was assigned its security interest in the vehicles in connection with a loan sale by Clark's lender, CIT Group/Equipment Financing, Inc. ("CIT") (the party reflected as the lienholder on the vehicles' certificates of title), did not properly perfect its liens under Texas's certificate of title statute because CIT did not apply for new certificates of title reflecting Wells Fargo as the assignee lienholder.

Typically, a finance company that originates a motor vehicle loan in the State of Texas (as well as other assets subject to Texas certificate of title statutes such as manufactured homes, watercraft and utility security instruments) will file an application with the State for the issuance of a certificate of title reflecting the finance company as the lienholder on the related vehicle. Many of these companies finance their origination of such loans through term securitization transactions and/or temporarily through structured warehouse financing facilities. These financing techniques require that the finance company transfer such loans upon or shortly after origination to a special purpose finance entity (an "SPE") that will ultimately borrow money against the value of such loans and pledge its interest in the loans to a trustee or collateral agent that acts for the benefit of the lender (in a warehouse facility) or the noteholders and/or monoline guarantor (in a term securitization). When a loan is transferred (whether by sale or pledge) from a finance company to an SPE or from an SPE to a trustee or collateral agent, a corresponding application is generally not made with the Texas filing office to issue a certificate of title reflecting that the SPE and the trustee or collateral agent have become lienholders by assignment with respect to the related vehicle. Instead, parties to these transactions have relied on interpretations of the Texas Certificate of Title Act (the "Texas Act") and Chapter 9 ("Chapter 9") of the Texas Uniform Commercial Code (the "Texas UCC") that indicate that no such re-titling is necessary in order for a perfected security interest to reside in assignees of finance companies (and future assignees in the chain of assignment).

While Chapter 9 of the Texas UCC governs the creation of a security interest in a motor vehicle in Texas, it does not govern its perfection, which is governed by the Texas Act. A security interest in a motor vehicle created under Chapter 9 of the Texas UCC is perfected pursuant to Section 501.113 of the Texas Act when application is made to the proper filing office reflecting the lienholder's interest in the vehicle. Section 501.114(a) of the Texas Act addresses the assignment of a lien in a motor vehicle properly perfected under Section 501.113:

A lienholder may assign a lien recorded under Section 501.113 by:

1. applying to the county assessor-collector for the assignment of the lien; and
2. notifying the debtor of the assignment.

Prior to the *Clark Contracting* decision, auto finance companies, banks and warehouse lenders and their legal counsel had interpreted Section 501.114(a) of the Texas Act to be permissive, that is, the use of the word "may" indicated that the statute did not require an assignor or assignee to comply with its provisions in order to effect an assignment of a lien or for perfection in that lien to continue in an assignee. There have been no published judicial interpretations of Section 501.114(a) of the Texas Act until *Clark Contracting*, so assignees have relied on (i) the fact that if the legislature had intended the procedures set forth in Section 501.114 to be the sole method of making a valid assignment of a perfected lien it would have used more precise language indicating that to be the case and (ii) the official comments to Section 9.310 of Article 9 ("Article 9") of the Uniform Commercial Code ("UCC") and that of the UCC Permanent Editorial Board (the "PEB") in PEB

Commentary No. 12 on Section 9-302 (that section of pre-Revised Article 9 that addressed matters now covered by Section 9.310 of Revised Article 9) (the "PEB Commentary").

The PEB Commentary states that while Article 9 provides that matters of perfection of motor vehicles are governed by a state's certificate of title statute, matters of assignment of that perfected security interest may be governed by Article 9 if the assignment provisions in the certificate of title statute do not relate to perfection. Some states have made it explicit in their motor vehicle certificate of title statutes that re-titling is not necessary to perfect an assignment of a security interest in an assignee, and, therefore, because such assignment provisions do not relate to perfection, Article 9 provisions govern the effect of assignment on perfection. In many states, including Texas, assignment provisions in the certificate of title statutes don't address, or are ambiguous as to whether they address, continued perfection of an assigned lien in the assignee. In such cases, the PEB Commentary notes that judicial interpretation has been that certificate of title statutes should be construed in harmony with the general UCC scheme for perfection of security interests, which in the case of assignment of security interests can be found in Section 9.310(c) of the Texas UCC.[1] Section 9.310(c) provides that a secured party that assigns a perfected security interest need not make any filing under Chapter 9 of the Texas UCC in order to continue the perfected status of the assignor in the assignee against creditors of and transferees from the original debtor, including any judgment lien debtors. In addition, Section 501.005 of the Texas Act states that conflicts between provisions found in the Texas Act and the Texas UCC are to be resolved in favor of the provisions set forth in the Texas UCC.

In *Clark Contracting*, the bankruptcy court concluded that the language of Section 501.114 **unambiguously requires** that application for re-titling must be made in order for an assignee of a lienholder to perfect its interest in a titled vehicle. By concluding that there was no ambiguity or conflict with the Texas UCC, the court avoided application of Section 501.005 and the rationale set forth in the PEB Commentary. The bankruptcy court noted that the Texas Act does provide notice to third parties of the existence of a prior lien on a motor vehicle through notation of a lienholder on the certificate of title, but claims that the Texas Act must have a procedure in place to make sure that assignees are reflected on the face of the certificate of title in order to be consistent with "the larger scheme of perfection" adopted in the" Texas Act, and that Section 501.114 provides that procedure by mandating recordation of the assignee's lien on the certificate of title. However, the bankruptcy court failed to reconcile why Section 9.310(c) of the Texas UCC provides that no such recordation procedure is necessary for assignments with respect to all other asset types. Much like the existence of a financing statement filed against a debtor under Chapter 9, the reflection on a certificate of title of the existence of a lien on a motor vehicle serves to put the world on notice that the vehicle is subject to a lien and furthers the underlying purpose of the perfection scheme of the Texas Act without requiring the identification of the assignee lienholder.

The bankruptcy court also reasoned that other provisions in the Texas Act regarding relation-back to the original lienholder's date of perfection make it clear that Section 501.114 mandates application for re-titling in order to perfect assigned liens. Again, there is no explanation why recordation of assignees' interests are necessary under the Texas Act to achieve relation-back perfection, yet Chapter 9 of the Texas UCC provides for relation-back without a need to require recordation of assignment.

The bankruptcy court apparently ignored the PEB Commentary that "a strict and literal construction of a certificate of title statute should be avoided if it produces a result that unnecessarily conflicts with the Uniform Commercial Code" and Section 501.005 of the Texas Act, which requires conflicts to be resolved in favor of Chapter 9.

The bankruptcy court also attempts to make public policy arguments to bolster its interpretation of the Texas Act. The court claims that reflection of an assignee lienholder on the certificate of title is critical to the debtor, third parties and law enforcement, however, the court again does not differentiate the Texas Act from the Chapter 9 scheme, which does not consider reflection of the assignee secured party on a financing statement critical. The risk of prejudice to the vehicle owner (the "account debtor") or any third party because of the failure to make public record of the assignment of a lien is minimal. Section 9.406 of the Texas UCC provides protection to account debtors by providing for a notification scheme regarding assigned liens and the identity of the assignee, which provisions apply to motor vehicles and other certificate of title assets. As a result, risks associated with an assignee's election not to re-title under the Texas Act would generally be borne by the

assignee, not the account debtor.

As a result of the court decision, assignees of loans secured by Texas autos and other collateral governed by Texas certificate of title statutes that have not filed to be registered as lienholders on certificates of title may no longer be deemed to hold a perfected security interest in such collateral.[2] Consequently, sellers and borrowers that have assigned loans may be in default of their loan or sale agreements and may either be forced to repurchase their Texas loans or complete and submit applications to the Texas filing offices for re-titling. The number of affected loans is estimated to be in the millions. The Clark Contracting decision appears to isolate Texas as the only state that interprets its certificate of title statute to, without exception[3], require re-titling of assigned motor vehicle liens to continue perfection in assignees.

The effect the bankruptcy court's decision will have on the future availability and cost of credit to Texas consumers and businesses that purchase and finance autos and other assets subject to Texas certificate of title statutes is difficult to quantify at this time, but it can be expected to result in a chilling effect on capital inflow into Texas for financing of these assets. At least one auto finance company decided to remove all Texas auto loans from its recently completed securitization due to concerns about the bankruptcy court's decision, and other companies are questioning whether Texas loans will be suitable for securitization or sale unless the expensive and time consuming re-titling is completed.

Industry leaders and associations, including the American Securitization Forum and the Texas Business Law Foundation, have 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 effect the assignment of a lien or to continue perfection of an assigned lien in the assignee. In addition, Wells Fargo has indicated that it intends to appeal the *Clark Contracting* decision, and industry leaders and associations are preparing to support such efforts in order to avoid a result that would have a devastating affect on Texas consumers and businesses in the middle of the worst economic crisis in the past half century.

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[1]The PEB
Commentary states that "a strict and literal construction of a certificate of title statute should be avoided if it produces a result that unnecessarily conflicts with the Uniform Commercial Code" and that when confronted with "the question of whether an assignee must do something under a certificate of title statute to continue the perfected status of an assigned security interest when the statute contains provisions on assignments but does not specifically mandate any action by the assignee for perfection, or make no or only isolated references to assignments, or is ambiguous as to what action an assignee must take and makes no mention of the consequence of the assignee's failure to take action with respect to the issue of perfection" that a court should avoid taking a position that would produce such a conflict. The PEB Commentary concludes that unless otherwise expressly required by a certificate of title statute, assignment provisions in certificate of title statutes should be not interpreted to require re-titling by assignees in order to maintain perfection in security interests assigned them by assignors.

[2] The bankruptcy court did not address, however, whether CIT, the assignor of the six Wells Fargo loans and the lienholder reflected on the certificates of title, is the perfected lienholder. If CIT did not comply with Section 501.114 of the Texas Act because it did not re-title in the name of Wells Fargo, it puts into question whether the CIT liens were effectively assigned together with the loans and, therefore, whether CIT could make a secured claim in bankruptcy to the related vehicles on behalf of Wells Fargo.

[3] We note that Maine's motor vehicle certificate of title statute does require re-titling for perfection to continue in assignees except in those cases where the noted lienholder continues to service the related loan on behalf of the assignee.

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