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DISPATCHES FROM THE TRENCHES

BE VERY WEARY ABOUT RELYING ON CERTIFICATES OF TITLE WHEN YOUR LEASED TRUCKS ARE BEING SUBLEASED

Equipment lessors of over the road trucks may find themselves being inventory lessors. The use of over the road trucks is a highly regulated industry requiring a variety of licenses, tax and other complications and it is not at all uncommon for a user of an over the road truck to lease with a carrier to obtain the benefit of certain operating licenses and of complying with tax and other legal requirements. As a result, finance lessors who engaging in the leasing of such vehicles often find themselves in lease-sublease situations. When the leased vehicles are subleased, these equipment lessors become inventory lessors for certain purposes under state law and the law applied in bankruptcy.

This classification occurs under the Uniform Commercial Code (the "UCC") which defines inventory as goods that 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. There are a variety of issues triggered by the leasing of inventory which are beyond the scope of this article, such the ability of a lessee of inventory to pass on to a sublessee greater interest than the lessee was originally given by the lessor under §§ 9-320, 2-403 and 2A-305.

In addition, there are special perfection rules for purchase money security interest in inventory under 9-324(b) of the UCC. In most circumstances, lessors file a UCC Financing Statement that describes the leased property as collateral and Lessee as debtor in case the underlying transaction is, or is at least is deemed by a court to be, a "lease-intended-as-security" or loan instead of a "true lease."

The issue here, and the focus of this article in the context of vehicle leases, is that obtaining a pmsi in "inventory" requires that: (a) a lessor file its UCC financing statement before the lessee receives possession (i.e. the twenty day grace period applicable to purchase money security interests in equipment does not apply with respect to inventory); and (b) the lessor send notices which must be received by holders of conflicting security interests within five years before the lessee receives possession of the leased goods. These conditions not only require the lessor to file its financing statement much earlier than normal, they also require the lessor to conduct a UCC search to learn of conflicting security interests and to send official notices to all holders of such interests.

To the extent the lessor is the true owner of the leased vehicles for UCC purposes, there is technically no need to "perfect" its interest by notation on the Certificate of Title or by filing a financing statement. This provides comfort to lessors engaged in TRAC leases since many states contain TRAC statutes noting that the terminal rental adjustment clause in such transactions does not, in and of itself, prevent the transaction from being a true lease for state law purposes. As a result, many courts treat such transactions as true leases outside the scope of Article 9 of the UCC without any intense analysis. However, lessors leasing vehicles on dollar-out leases or otherwise pursuant to leases intended as security need to be aware of the perfection risks posed by the classification of the vehicles as inventory.

Many think that the perfection issue is not a problem when the "inventory" consists of motor vehicles since such equipment is generally covered by a certificate of title. Upon a quick glance, it would *appear* that, since certificate of title laws generally govern the notation of security interest, the more burdensome rules governing purchase money

security interest in inventory are inapplicable when the leased equipment consists of motor vehicles.

This comfort stems from language in §9-311 of the UCC which generally states that the provisions of the UCC do not apply with respect to the perfection of 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, and any non-Uniform Commercial Code central filing statute.

However, a more detailed reading of §9-311 reveals a troublesome exclusion. Subsection (d) states: "during any period in which collateral 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 of that kind, this section does not apply to a security interest in that collateral created by that person as debtor." The effect of this exclusion is to require same sort of treatment of security interest in automobiles being subleased as required with any other inventory.

A case in point is *In Re Babaeian Transportation Company*, 32 UCC Rep. Serv.2d 275 (1997). In that case, the Trustee in bankruptcy sought to avoid the lien of Chrysler Credit Corporation arguing that, because the vehicles constituted inventory, Chrysler Credit Corporation could only perfect its security interest by filing a UCC-1 financing statement in the appropriate jurisdiction and could not do so merely by noting itself as the lienholder on the title.

The Court agreed noting that "California statutes provide two different methods of perfecting a security interest in a vehicle. If the vehicle is inventory, perfection may only be accomplished by filing a UCC-1 financing statement in the Office of the Secretary of State. In all other cases, security interests may be perfected only by obtaining a certificate of ownership for the equipment [properly designating the secured party as a lien holder]." *Id* at 542.

The Court continues by nicely explaining the purposes of the exception stating that it would basically be awkward and inconvenient to require a lender that is floor planning vehicles to obtain certificate of title endorsements on a changing inventory of several hundred vehicles as a condition of financing an automobile dealer. It would be equally burdensome on state authorities to process that large quantity of paperwork. The filing of UCC-1 financing statement is a far more efficient and easy way to deal with such security interest. The Court eventually held that all of the leased vehicles were inventory and sided with the Trustee, invalidating Chrysler Credit Corporation's security interest.

Of particular note is the Court's discussion of how the collateral classification can change during the term. In the case at bar, certain vehicles were used by the borrower in its ordinary course of business and therefore constituted "equipment" under the UCC. Chrysler Credit had properly perfected its interest by noting its interest on the certificate of title in accordance with the certificate of title statute.

However, at some point, a third party named Schaffer left the borrower and "took" 6 vehicles with him. A Court determined that because Borrower was still listed as owner on the titles but Schaffer was using the vehicles, that their use must be in connection with a sublease or a contract of service, therefore making the vehicles "inventory" at the time Schaffer "took" them. Faced with these facts, Chrysler Credit Corp. argued that the change in use from equipment to inventory would not defeat its prior security interest in equipment which was properly perfected by a notation on the certificate of title. The Court disagreed quoting specific language in the statute requiring that the UCC be the method of perfection "during any period in which collateral is inventory." According to the Court, the only way to perfect its interest once Schaffer began leasing the vehicles was to have a properly filed UCC.

The lesson is clear: unless you are sure that the underlying transaction constitutes a true lease or credit is not requiring a first priority security interest in the leased vehicles,

allowing you lessee to sublease motor vehicles requires more due diligence than simply noting your interest on a certificate of title.

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