

FINANCING VEHICLE LESSORS & DEALERS:  
IS IT INVENTORY?

Perfection of security interests in collateral governed by certificate of title requirements poses two (2) traps for the unwary. First, the secured lender must identify the manner of perfection (i.e., by identification of the lien on the title certificate or by filing a UCC-1 describing the collateral). Second, when disposing of collateral after a default by the borrower, the secured lender must determine what search to conduct to locate holders of security interests in the same collateral -- a search of the UCC records or a search at the recording office where title certificates would be filed (i.e., Department of Motor Vehicles)?

In the classic case of a single purpose financing between a lender and a borrower of a motor vehicle where the borrower is not in the business of selling or leasing motor vehicles, the analysis is straight-forward. New York, like many other states, is a "Certificate of Title" state which generally means that the perfection of a security interest in titled vehicles is accomplished by identification of the lien on the face of the Certificate of Title. This is recognized in UCC§9-311(a) which states in relevant part as follows: "except as otherwise provided in subsection (d), the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to... (2) a certificate-of-title statute to the extent such statute or regulations provide for a security interest to be indicated on the certificate as a condition or result of perfection...".

As such, the security interest would be exclusively recorded on the Certificate of Title. If a borrower defaults on a loan obligation, then we look to UCC§9-611(c) to determine to whom the secured lender must give notice. In addition to notice upon the debtor and guarantor, notice must also be given to a secured party or lien holder that, ten (10) days before the notification date, held a security interest in or other lien on the collateral to be sold perfected by the filing of a financing statement or as otherwise perfected by compliance with a statute, regulation, or treaty (the "Other Lienors").

A record search at the state office for filing certificates of title would be required to give proper notice under UCC§9-611(c).

So, where's the "trap"? The trap exists in understanding the nature of the financing and the business in which the borrower is engaged. Suppose a funding source establishes a dealer agreement for a vehicle lessor or provides a loan facility secured by a portfolio of vehicles and vehicle leases? The lessor, depending on the economics of the transaction, will either denote itself as owner or secured party on the certificate of title. *But what about the lender to the Lessor?* It will likely require its name on the title certificate, hold the certificate of title or a combination of both. *Is that enough?* And what about disposition of the vehicle if the lessee defaults -- to whom must lender give notice?

The answers lie in UCC§9-311(d) which contains an "exception" to the certificate of title rule when you are perfecting a security interest in certain **inventory** and, in those situations, a lender **must file a financing statement**. This statute is intended to cover, at least, the classic floor plan finance company's perfection of its security interest in all of the vehicles financed under the floor plan while those vehicles remain as the dealer's inventory. In this common situation, UCC§9-311(d) indicates that lender must file a financing statement to perfect its security interest in vehicle inventory.

Prudence, therefore, would require the secured lender to file a UCC-1 against its borrower (the lessor/dealer) identifying as collateral, among other things, all vehicles and leases financed under the dealer agreement or master loan. This is particularly so because the lessor may acquire possession of vehicles either at the end of a lease or upon a lessee's default. In fact, some courts have held that the lessor's inventory rights extend while the vehicle is in the lessee's possession because of the lessor's residual interest. Similarly, if the lender seeks to dispose of the vehicle in the lessor's possession, does notice of disposition require a UCC search on the lessor to see if anyone has a security interest in the "lessor's inventory"? **If perfection by UCC filing is required, then notice upon default will require a UCC search of the lessor.**

If the collateral is vehicle 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 of that kind, a secured party must perfect its security interest by filing a financing statement. The statute indicates that whether or not the debtor (lessor/dealer) sells or leases a vehicle, it must also “sell goods of that kind” in order to perfect by filing. There may be many dealers or lessors in a vehicle lender's portfolio that do not maintain conventional showrooms and are not traditional car dealers but act more as leasing brokers that match leased vehicles to lessees and hence a lender may be forced to decide whether or not that dealer/lessor “sells goods of that kind”. The Official Comment to UCC§9-311(d) states that the fact that the debtor eventually sells the goods does not, **of itself**, mean that the debtor “is in the business of selling goods of that kind”.

Based upon the above, if a borrower is in the business of leasing but not of selling vehicles, one could only perfect the security interest in the vehicle inventory by complying with the certificate of title statute. Since in that situation a competing lender/lien holder would not perfect by filing, a UCC search and a Notice of Sale upon those that filed UCC-1s would not be required unless the lien is reflected on the title certificate.

### **BUT WHEN IS THE DEALER/LESSOR IN THE BUSINESS OF SELLING VEHICLES?**

One commentator has stated that the phrase “of itself” suggests that whether a leasing company is also “in the business of selling” used vehicles is a fact specific issue. Relevant factors could include total value of used fleet sales, percentage of debtor's income or profits attributable to sales, residual value left in the vehicles at the time of sale, how the debtor holds itself out to third persons in its advertising and financial statements, and the method of selling the used vehicles at the end of their useful life as part of the debtor's rental fleet.

This analysis confirms, at least in one commentator's view, that a determination of whether or not a borrower is in the business of selling vehicles may be complex. Moreover, much of the data needed for this analysis may not be within the lender's knowledge or control. However, even if this knowledge was easily ascertained, these are simply some of the factors which would assist a Court in deciding whether or not the borrower was “in the business of selling”. Perhaps more importantly, these factors cannot provide a lender with a “bright line” answer as to when it should, or should not, perfect by filing and search UCC records for Other Lienors and send them a Notice of Sale.

### **WHAT SHOULD A SECURED PARTY DO?**

It is our recommendation that the prudent approach is to always search the UCC records of a dealer/lessor when disposing of vehicles financed through the lessor portfolio and send a Notice of Sale to those who purport to hold a security interest in the lessor's vehicle inventory rather than to rely upon a determination of whether or not a borrower “is in the business of selling”.

The problem is one of practicality in that secured parties that foreclose on their vehicles may be repossessing them sporadically and may be forced to conduct UCC lien searches on their dealer/lessor each time they notice a sale (as UCC§9-611(c) (4) has a timeliness requirement in that you must notify all parties holding valid liens in the vehicle to be sold as of ten (10) days before the date of the Notice of Sale).

As is often the case with all perfection issues, the prudent approach is to file a UCC financing statement when you are in doubt and, applying that rule to the Notice of Sale to be provided to Other Lienors, it would be equally prudent to perform a UCC lien search before you send a Notice of Sale.

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