

When Your Car Dealership



Goes Broke

In February of this year, Lawrence Marshall, a large car dealership in Hempstead, Texas, closed its doors. This closing had a significant effect on the Hempstead community, but Lawrence Marshall was just one of many car dealerships closing down across the country. Nearly 1,000 dealerships went under in 2008 because of the credit crunch and the faltering economy.¹

Car dealerships going broke can cause a variety of headaches for consumers. This Article addresses one set of problems consumers might face relating to trade-ins. When consumers trade in their cars, the car dealership usually promises to pay off the loan the consumer had on the car that the consumer traded in. If the dealership fails to pay off that loan, what happens to the loan? Does the consumer still have to pay it off? In a related question, what happens if the dealership sells the trade-in to a new buyer without ever paying off the loan to the consumer who traded in the car? Does the new buyer get clear title to the trade-in?

The Lawrence Marshall closing revealed the real potential of these two situations arising: Employees of the dealership stated that trade-in payments had not been made for several weeks before the closing.² Indeed, the Better Business Bureau had received complaints that the dealership failed to pay off trade-in vehicles for the past four or five years.³ Though the Sales Manager at Lawrence Marshall told reporters that the trade-in payments would all be paid,⁴ we are left to wonder what could happen if the loans were not paid off. In other dealership closings, traded-in vehicles have not been paid off, and consumers were left with the loan for their trade in and the loan for their new car.⁵ Considering that a quarter of consumers trading in their cars still owe money on the cars,⁶ the potential ramifications of this problem are significant.

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This Article analyzes these two situations. Part I explains that a lender's security interest in a car that is traded in to a dealer survives the trade in. The lender can repossess the car that was traded in and repossess the new car the consumer purchased from the dealer. If, after selling the property, a balance remains on the loan, the lender can seek the deficiency from the consumer who traded the car in. In Part II, things get worse. A buyer who purchases a car that has an unpaid loan is subject to the lender's security interest. The lender can repossess the car from the second buyer just as it could if the consumer who traded it in still possessed the car.

I. The Lender's Security Interest in a Vehicle Survives a Consumer Trading the Vehicle In to a Dealership

This Part demonstrates why a lender's security interest exists even if the consumer trades the vehicle in. To collect on the loan, the lender can take several steps, including repossessing the vehicle from the dealership and repossessing the consumer's new car.

a. The Lender's Continuing Security Interest

To understand how a loan survives the trade-in process, it is important to review how a lender obtains an interest in a vehicle as collateral. To obtain a valid security interest and to perfect that interest, a lender usually turns to Article 9 of the Uniform Commercial Code, enacted in Texas in the Texas Business and Commerce Code. The first step in the process, "attachment," occurs when the lender and the borrower sign the loan, which is called a security agreement in Article 9.⁷ Lenders in the situations relevant to this article obtain a purchase-money security interest in the consumer's vehicle through the security agreement because the debt is "an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used."⁸ Simply put, the lender has a purchase-money security interest because the consumer took out the loan to get the car, and the car serves as the collateral for the loan. To "perfect" a security interest in a motor vehicle, the second step in the process, Article

9 requires a lender to follow the procedures in the Certificate of Title Act.⁹ Under the Certificate of Title Act, a lender perfects a security interest by recording the security interest on the certificate of title.¹⁰

If a lender complies with the Certificate of Title Act, then the security interest “remains perfected notwithstanding a change in the use or transfer of possession of the collateral.”¹¹ An unpublished opinion from the Fourteenth Court of Appeals shows this rule in action in a situation similar to the one created by a dealership closing down or declaring bankruptcy.¹² In *Conseco Finance*, a motor home dealer sold a motor home to Lila Williams who signed a security agreement with Conseco Finance Servicing Corporation.¹³ The motor home dealer reacquired the motor home (through unknown means and for unknown reasons) and sold the motor home to Robert and Ann Lee.¹⁴ Williams, the first buyer, defaulted on her loan with Conseco Finance, and Conseco Finance sued her for breach of contract.¹⁵ The Lees, the second buyers, sued Conseco Finance for a declaration that the Lees had complete and unencumbered title to the motor home.¹⁶

Conseco Finance argued that the Lees purchased the motor home subject to Conseco Finance’s security interest because Texas Business and Commerce Code § 9.311(b) states that a security interest perfected through the Certificate of Title Act remains perfected notwithstanding a transfer in possession of the collateral.¹⁷ The court agreed that Conseco Finance’s security interest survived not only the dealer’s reacquisition of the motor home from the first buyer, Williams, but also the Lees’ purchase of the motor home from the motor home dealer.¹⁸ This holding is important for the discussion in Part II of this Article

Cases from other jurisdictions follow the exact reasoning in *Conseco Finance*. For instance, in *In re Sunrise R.V. Inc.*, a bankruptcy court encountered a situation in which a consumer traded in a recreational vehicle, but the dealership filed for bankruptcy before paying off the lien on the vehicle.¹⁹ The bankruptcy court explained that although Article 9 “ostensibly shift[s] the risk of loss from the good faith purchaser to the secured party[,] the Commercial Code will not generally insulate a good faith purchaser of a used vehicle from the claim of a lienholder whose lien on said vehicle was never satisfied due to the default of an insolvent dealer.”²⁰ As one California Court of Appeals reaching the same conclusion put it: The facts of these cases are difficult because no one except the dealer is at fault, but legally, “the case is simple.”²¹

b. The Lender’s Rights in Seeking Repayment

If the consumer sells a car to a car dealership as a trade-in and the dealership fails to pay off the loan, the consumer is left in the unenviable position of owing a debt on a car which the consumer no longer owns and potentially on a new car just purchased from the dealership. Often in these situations, the consumer will default on the loan covering the vehicle that was traded in. If the consumer defaults, what can the lender do?

i. Repossessing the Trade-In Vehicle from the Dealership

First, a lender has the right to repossess the trade-in from the dealership. Typically, the lender’s interest as a secured party with a purchase-money security interest is superior to the dealership’s interest as a purchaser. The dealership as purchaser could potentially take the vehicle free of the lender’s interest under section 9.317(b), which allows buyers to take goods free of security interests if “the buyer gives value and receives delivery of the collateral without knowledge of the security interest or

agricultural lien and before it is perfected.”²² Dealerships in our scenario, however, would fail to qualify under this provision because they would know of the loan (that they promised to pay off) and because the lender will almost certainly have perfected its security interest. Yet, Article 9 gives some buyers priority over a lender even in these circumstances: “[A] buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by the buyer’s seller, even if the security interest is perfected and the buyer knows of its existence.”²³ The important question is whether the dealership is a buyer in the ordinary course of business. Under the definition of this term in section 1.201(9), the dealer is not a buyer in the ordinary course of business because the consumer, who is the seller in the case of the trade-in, is not in the business of selling goods of that kind, as required by the definition.²⁴ Because the lender’s interest in the trade-in has priority over the dealership’s interest, the lender can repossess the vehicle from the dealership if the consumer/debtor defaults on the loan.²⁵



ii. Repossessing the Consumer’s New Vehicle

In addition to repossessing the trade-in from the dealership, the lender could look to repossess the consumer’s new vehicle. Unless the parties agree otherwise, a secured creditor has the right to “proceeds” that are generated by the collateral.²⁶ “Proceeds” are defined as, among other things, “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral.”²⁷ In the situation where a vehicle is traded in exchange for a new vehicle, the new vehicle is proceeds because it is something acquired upon the exchange of collateral.

A lender’s security interest in the new vehicle the consumer purchases is a perfected security interest because the original collateral, the trade-in, was perfected.²⁸ The lender loses the perfection of the security interest in the new car if 20 days pass without the lender taking the appropriate steps to perfect its interest.²⁹ But even if the lender’s interest in the car is unperfected, the lender can still repossess the new car pursuant to section 9.609 of Article 9. This section gives a secured party the right to take possession of “the collateral” after the consumer defaults, and the definition of collateral includes proceeds.³⁰ Section 9.609 does not require that the lender’s security interest be perfected for the lender to repossess the collateral; it only requires the debtor to

default on the loan secured by the collateral.

The comments to Article 9 make plain that a lender may repossess the trade-in from the dealership or the new car from the consumer or both:

Subsection (a)(1), which derives from former Section 9-306(2), contains the general rule that a security interest survives disposition of the collateral. In these cases, the secured party may repossess the collateral from the transferee or, in an appropriate case, maintain an action for conversion. The secured party may claim both any proceeds and the original collateral but, of course, may have only one satisfaction.³¹

The comment points out that the lender cannot recover more than the original loan by repossessing both the trade-in and the new car, but the lender has the option of how to proceed. The real problem that consumers in this situation might encounter is not that lenders will have more than one satisfaction but that the lender will resell the trade in and not generate sufficient funds to repay the loan. The next section addresses who is liable for the deficiency in that situation.

iii. Seeking a Deficiency from the Consumer

If the lender repossesses either the trade-in itself or the consumer's new car, the lender will sell the repossessed property and use the money from the sale to repay the loan.³² A problem arises, however, if the money the lender recovered is less than the amount of the loan. Article 9 calls this amount a "deficiency" and specifies that "the obligor is liable for any deficiency."³³

This leads to the question of whether the dealership that now owns the trade-in or the consumer who took out the original loan is the *obligor*. Under Article 9, obligor "means a person that, with respect to an obligation secured by a security interest in or an agricultural lien on the collateral . . . owes payment or other performance of the obligation."³⁴ The dealership, by taking the trade-in and promising to pay off the loan, has an obligation to the consumer, but the consumer and the dealership cannot alter the contract between the lender and the consumer without the consent of the lender. The consumer can, of course, sue the dealership or make a claim against the dealership's estate if the dealership has filed for bankruptcy, but neither option offers the chance of substantial recovery because the dealership is, we assume, broke. Thus, the consumer remains the only obligor on the loan for the car and is liable for any amount left on the loan after the lender sells the collateral.³⁵

Ironically, though the consumer is liable for a deficiency, if the lender recovers more than the amount of the debt when it sells the repossessed vehicle, the dealership, not the consumer, would be entitled to the surplus. Comment 5 to section 9-615 explains:

When the debtor sells collateral subject to a security interest, the original debtor (creator of the security interest) is no longer a debtor inasmuch as it no longer has a property interest in the collateral; the buyer is the debtor. As between the debtor (buyer of the collateral) and the original debtor (seller of the collateral), the debtor (buyer) normally would be entitled to the surplus following a disposition. Subsection (d) therefore requires the secured party to pay the surplus to the debtor (buyer), not to the original debtor (seller) with which it has dealt.³⁶

Though the dealership has caused the problem, the consumer is left with the bill if the repossessed collateral is insufficient, and the dealership is paid if the sale of the collateral produces more money than is owed on the loan. If the dealer has already sold the trade-in, however, we have a new party to complicate things. In the same way the law leaves the consumer who sells the trade-in

unprotected, the law also fails to protect the party who buys the trade-in from the dealership.

II. The Lender's Security Interest in a Vehicle Survives the Dealership Selling the Vehicle to a Second Buyer

In addition to the problem the consumer selling the trade in faces if the dealership does not pay off the loan secured by the trade-in, a second buyer who purchases the trade-in from the dealership is also subject to the lien the lender has on the trade-in. The second buyer's best hope of avoiding the lender's lien is, just as the dealership, to claim to be a buyer in the ordinary course because such a buyer would take the trade-in free of the lender's interest.³⁷

The dealership fails to qualify under the definition of a buyer in the ordinary course because the consumer trading in the car did not ordinarily sell cars.³⁸ The second buyers, on the other hand, are buyers in the ordinary course because dealerships are "in the business of selling" cars.³⁹ Thus, second buyers appear to have the potential to take the vehicle free of the lender's interest.

Unfortunately, the second buyers run into a different problem. Buyers in the ordinary course of business take property free of security interests "created *by the buyer's seller*," not other parties.⁴⁰ The dealership is the seller of the trade-in, but the dealership did not create the security interest in the trade-in—the consumer trading the car in did. Thus, the second buyer is still subject to the lender's interest. An example from the comments to section 9-320 mirrors the situation and explains the result:

Manufacturer, who is in the business of manufacturing appliances, owns manufacturing equipment subject to a perfected security interest in favor of Lender. Manufacturer sells the equipment to Dealer, who is in the business of buying and selling used equipment. Buyer buys the equipment from Dealer. Even if Buyer qualifies as a buyer in the ordinary course of business, Buyer does not take free of Lender's security interest under subsection (a), because Dealer did not create the security interest; Manufacturer did.⁴¹

The result is tragic for the second buyer because the lender can repossess the trade-in for the exact same reasons it could repossess the trade-in from the dealership.⁴²

The *Conseco Finance* opinion again applies these principles in the context of Texas law. In *Conseco Finance*, the buyers of the motor home that had been traded in, the Lees, claimed to be buyers in the ordinary course of business under section 1.201(9), giving them title to the motor home free of any security interest pursuant to section 9.320(a).⁴³ The court held that the lender's, Conseco Finance's, security interest survived the Lees' purchase of the motor home from the motor home dealer.⁴⁴ The court rejected the Lees' argument that they acquired the motor home free of Conseco Finance's security interest as buyers in the ordinary course because New World, the seller, did not create the security interest in the motor home. Instead, the first buyer, Williams, created the security interest.⁴⁵ Though the dealership was involved in the transaction that created Conseco Finance's security interest in the motor home, the dealership was not the

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debtor, so the court reasoned that section 9.320(a) did not apply to the Lees' purchase.⁴⁶ Because the security interest remained, Conseco Finance could repossess the motor home from the Lees.⁴⁷

Conclusion

As *Conseco Finance* illustrates, in both the case of the person trading in the vehicle and the case of the person buying the trade-in, the law leaves consumers unprotected, except to the extent they can pursue the dealership who caused the problem and who has either closed down or filed for bankruptcy. Though the case against the dealership may be a slam dunk, the victory is hollow because collecting would likely be impossible. Without another form of recovery, Article 9 only creates problems for consumers confronting dishonest or impecunious dealerships.

In other states, consumers can seek protection from other state laws. Some states' laws require car dealerships to post insurance bonds to repay consumers who are left out in the cold by a dealership. For instance, in California and Iowa, dealerships must post a \$50,000 bond to repay consumers whose trade-in is unpaid or who acquire a car that is subject to a lien.⁴⁸ But, until Texas establishes a similar requirement, consumers—both those selling cars to dealerships and those buying used cars—are left with the old maxim: *caveat emptor*.

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1 *Huge Texas Auto Dealer Goes Broke*, ABC News, Feb. 5, 2009, available at http://abclocal.go.com/wjrt/story?section=news/national_world&id=6642394&rss=rss-wjrt-article-6642394 (last visited Apr. 13, 2009).

2 Jeff Ehling, *Fallout from Lawrence Marshall Closing*, ABC NEWS, Feb. 5, 2009, available at <http://abclocal.go.com/ktrk/story?section=news/local&id=6643637&rss=rss-ktrk-article-6643637> (last visited Apr. 13, 2009).

3 Bill Cawthon, *Big Chrysler Dealership Goes Under in Texas*, ALLPAR.COM NEWS, Feb. 5, 2009.

4 Ehling, *supra* note 2.

5 Meg Marco, *Zombie Trade-Ins: When the Dealership Goes Under, Your Old Car Comes Back to Haunt You*, THE CONSUMERIST, Dec. 1, 2008, available at <http://consumerist.com/5102112/zombie-trade+ins-when-the-dealership-goes-under-your-old-cars-come-back-to-haunt-you?skyline=true&s=x> (last visited Apr. 22, 2009).

6 *Closing Car Dealers Stun Buyers With Liens on Trade-In*, ABC NEWS, Feb. 1, 2009, available at <http://cbs13.com/local/folding.dealers.car.2.923931.html> (last visited Apr. 23, 2009).

7 TEX. BUS. & COM. CODE §§ 9.201, 9.203.

8 See *id.* § 9.103(a)(2) (defining purchase-money obligation, which is used in Tex. Bus. & Com. Code § 9.103(a)(1) to define purchase-money collateral, the central term in the definition of purchase-money security interest in Tex. Bus. & Com. Code § 9.320(b)).

9 See *id.* § 9.311 (b) (“[F]or goods covered by a certificate of title, a security interest . . . may be perfected only by compliance with those requirements . . .”).

10 TEX. TRANSP. CODE § 501.111(a) (Vernon 1999).

11 TEX. BUS. & COM. CODE § 9.311(b).

12 *Conseco Fin. Serv. Corp. v. Lee*, No. 14-03-01194-CV, 2004 Tex. App. Lexis 5035 (Tex. App.—Houston [14th Dist.] June 8, 2004, no pet. h.).

13 *Id.* at *2.

14 *Id.*

15 *Id.* at *2-3.

16 *Id.* at *3.

17 *Id.* at *14.

18 *Id.* at *16.

19 105 B.R. 587, 589 (Bankr. E.D. Cal. 1989).

20 *Id.* at 591.

21 *Gordon v. Hamm*, 63 Cal. App. 4th 1324, 1331 (Cal. Ct. App. 1998).

22 TEX. BUS. & COM. CODE § 9.317(b).

23 *Id.* § 9.320(a).

24 *Id.* § 1.201(9).

25 See UNIF. COM. CODE § 9-609 cmt. 5 (“More than one secured party may be entitled to take possession of collateral under this section. Conflicting rights to possession among secured parties are resolved by the priority rules of this Article. Thus, a senior secured party is entitled to possession as against a junior claimant.”).

26 TEX. BUS. & COM. CODE § 9.203(f) (“The attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9.315 and is also attachment of a security interest in a supporting obligation for the collateral.”).

27 *Id.* § 9.102(a)(65).

28 *Id.* § 9.315(c).

29 *Id.* § 9.315(d).

30 *Id.* § 9.102(a)(12).

31 UNIF. COM. CODE § 9-315 cmt. 1.

32 TEX. BUS. & COM. CODE § 9.610(a).

33 *Id.* § 9.615(d)(2).

34 *Id.* § 9.102(60).

35 Even though the consumer is no longer a debtor because the collateral is sold, the consumer is still an obligor.

36 UNIF. COM. CODE § 9-615 cmt 5 (internal citations omitted).

37 See *supra* notes 23-25.

38 See *supra* notes 23-25.

39 TEX. BUS. & COM. CODE § 1.201(9).

40 *Id.* § 9.320(a). See also UNIF. COM. CODE § 9-320 cmt. 3 (“As did former Section 9-307(1), subsection (a) applies only to security interests created by the seller of the goods to the buyer in ordinary course.”)

41 *Id.* § 9-320 cmt 1.

42 See *supra* note 25.

43 *Conseco Fin. Serv. Corp. v. Lee*, No. 14-03-01194-CV, 2004 Tex. App. Lexis 5035 at *15-16 (Tex. App.—Houston [14th Dist.] June 8, 2004, no pet. h.).

44 *Id.* at *16.

45 *Id.*

46 *Id.*

47 *Id.* at *22-25 (citing the security agreement and 9.609 which gives a secured party the power to repossess collateral after default”).

48 *Closing Car Dealers*, *supra* note 6.