

Department of Finance and Administration

Legislative Impact Statement

Bill: HB2051 **Amendment Number: Engrossment 4/3/13 (Am #H1)**
Bill Subtitle: TO CLARIFY THE BANKRUPTCY LIEN AVOIDANCE STATUTES.

Basic Change :

Representative Wright

Under current law, a lien holder may obtain a lien in a motor vehicle through use of the direct lien method. This method requires the lien holder to enter the lien on either the vehicle's manufacturer's certificate of origin (MCO) or the vehicle's existing title and submit a copy of the document creating the lien to DFA. The lien and vehicle information is entered into DFA's motor vehicle system to provide notice of the lien. Under the bill, the lien holder would be able to perfect a lien by simply recording the lien on the MCO or existing title and would no longer be required to submit a copy of the document creating the lien to DFA. As a result, DFA's motor vehicle system would contain no information relating to the existence of the lien and there would be no notice of the lien from a check of that system. A vehicle owner could defeat the lien by simply applying to DFA for issuance of a duplicate title. Since DFA would be unaware that the lien had been recorded on the MCO or existing title, DFA would issue a duplicate title without the lien being shown. The vehicle owner could then sell the vehicle with a clear title to an unsuspecting purchaser. Currently when a person applies for a duplicate title, DFA checks the motor vehicle records to determine if a lien document has been filed with DFA. If a lien document has been filed and recorded in DFA's motor vehicle records, a duplicate title will not be issued until the owner presents a lien release or letter of permission from the lien holder. If this bill is adopted in its present form and a lien holder chooses to record their lien by simply noting the lien on the face of the MCO or existing title and does not submit a copy of the document creating the lien, clear duplicate titles will be issued by DFA without the outstanding liens being shown.

Revenue Impact :

None

Taxpayer Impact :

Since clear duplicate titles could be issued with outstanding liens, purchasers of vehicles could unknowingly purchase vehicles with outstanding liens.

Resources Required :

None

Time Required :

Adequate time is provided.

Procedural Changes :

Revise Motor Vehicle Procedures Manual to reflect the change and distribute to Revenue Offices.

Legal Analysis :

HB2051 amends Ark. Code Ann. §27-14-806(a), concerning optional means of recording a lien on a motor vehicle (a direct lien), to require that a lienholder either record its lien on the certificate of origin, or on an existing certificate of title, or file a copy of the lien instrument with DFA. Under current law, a direct lien is perfected only if the lienholder both records its lien on the vehicle's statement of origin or existing title and files a copy of the lien instrument with DFA.

Based solely upon the title of the bill, it appears the sponsor is concerned about a lender having its lien or interest in a motor vehicle voided or avoided in bankruptcy if the lien is determined to be unperfected. In order to understand what the bill is attempting to do, it is important to have a basic

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understanding of bankruptcy and the role of bankruptcy trustees. In the simplest of terms, an individual or entity may file bankruptcy when it is unable to pay all of its debts. At that point, generally a bankruptcy trustee is appointed to collect and reduce to money the property of a debtor's estate (generally all of the assets owned by a debtor at the time of the filing of the case) and determine the respective interests of creditors in the case for purposes of determining the priority and extent of any payment the creditor may receive from the Debtor's estate. The bankruptcy code sets forth specific priorities for payment to creditors. Generally, secured creditors holding liens or interests in property of the estate, such as a motor vehicle, will receive distribution ahead of other creditors of the debtor, but after payment of fees and other administrative expenses of the estate. After secured creditors are paid, priority creditors (such as taxing authorities not holding a lien) will receive payment, with the last creditors to receive payment being general unsecured creditors (such as credit card companies).

For purposes of HB2051, if a lender in Arkansas lends money to an individual or entity and takes a security interest in a vehicle, and that individual or entity later files a bankruptcy, the vehicle becomes property of the bankruptcy estate and is subject to liquidation for payment to creditors, even if there is a properly perfected interest in the vehicle (so long as there is sufficient equity in the vehicle to pay the debt still owed to a secured creditor). In order to ensure the lender receives payment, it is extremely important that the lender's security interest is perfected in the vehicle at the time the bankruptcy case is filed, because failure to perfect the security interest will impact whether and how the creditor will be paid by the trustee. However, it is important to note that an unperfected security interest is not void or invalid. Instead, the interest still exists, but the lender has the last priority against other lien creditors or a bona fide purchaser. In other words, if a trustee sells the vehicle, the persons who would receive payment from the proceeds would be the trustee and estate (for costs), other lien holders, and then the lender if funds are left over. Similarly, if no bankruptcy is filed, and the consumer sells the vehicle to a bona fide purchaser, the bona fide purchaser is not responsible to the lender for payment of the debt. In both instances, the lender may not receive payment from the trustee or the bona fide purchaser, but the security interest is still valid between the lender and the consumer.

HB2051 will make it easier for a lender to perfect a security interest in a vehicle through simply recording the lien on the manufacturer's certificate of origin or title or by filing a copy of the security agreement with DFA. However, if the lender perfects through simply filing the agreement with DFA, the vehicle is eligible to be sold without a notation of the lien on the title. In which case, the clear title would be transferred to a third party who would have no knowledge of the lien. Any third party interested in purchasing a used vehicle would have to contact DFA to see if there is a security agreement on file in order to verify the existence of a lien. If the agreement on file does not identify the vehicles secured by the agreement by make, model, and vehicle identification number, DFA would be unable to certify the existence of a lien. If DFA cannot certify the existence of a lien, a buyer takes the vehicle subject to his peril, or, which would be more likely, a court could easily determine that third parties did not have constructive notice of the existence of a lien and the lien would still be determined to be unperfected. Additionally, the mere filing of an agreement with DFA, regardless of whether it includes the identity of the vehicles, would subject the state to potential liability if DFA certifies no lien exists when such lien does exist.