IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
TYLER DIVISION

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| IN RE: | § | Case No. 98-61795 |
| | § | Chapter 7 |
| WILLIAM S. HART, | § | |
| LAURIE HART, and | § | |
| HART GENERAL CONTRACTORS | § | (Case Nos. 98-61794 & 98-61795 |
| | § | Substantively Consolidated |
| Debtors | § | Under 98-61795) |

**MEMORANDUM OF DECISION DENYING MOTION FOR RELIEF FROM STAY FILED BY CITIZENS STATE BANK**

This matter is before the Court upon two identical Motions for Relief from Automatic Stay[1] (the "Motion") filed by Citizens State Bank ("Bank") in these two companion Chapter 7 cases which have now been substantively consolidated. The Motion seeks relief from the stay in order to allow the Bank to pursue its state law remedies with regard to a 1982 Mack dump truck and a 1989 Gooseneck trailer (the "Truck and Trailer" or the "Property" ) against which the Bank asserts that it holds a perfected security interest. This Court has jurisdiction over this contested matter pursuant to 28 U.S.C. §1334 and 28 U.S.C. §157(a). This matter is a core proceeding pursuant to the provisions of 28 U.S.C. §157(b)(2)(A), (G) and (O). Based upon the Court's consideration of the pleadings, the evidence admitted at the hearing, and the argument of counsel, the Court makes the following findings of fact and conclusions of law pursuant to Fed. R. Civ. P. 52, as incorporated into contested matters in bankruptcy cases by Fed. R. Bankr. P. 7052 and 9014.

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[1]Since these cases have now been substantively consolidated by order entered on January 5, 1999, the Court will treat the two motions as a singular motion in the consolidated case and this memorandum of decision and the accompanying order resolves all issues raised by both motions.

## I. PROCEDURAL BACKGROUND.

On August 12, 1998, the Debtors filed their respective voluntary petitions for relief under Chapter 7 of the Bankruptcy Code. The Bank thereafter filed its motion for relief from the automatic stay, asserting various grounds including allegations that its interests in the Truck and Trailer were not being adequately protected, that no equity exists in the Property and the vehicle was not necessary for an effective reorganization. An objection to the granting of such relief was filed in each case by Bob Anderson, the duly-appointed Chapter 7 trustee (the "Trustee"), who asserted that the Bank had failed to properly perfect its interest in both the Truck and Trailer and, that he, as the representative of the bankruptcy estate, possessed an interest in the Property superior to that of the Bank. Thus the Court was called upon to resolve whether the Bank has a perfected security interest in the Property. A hearing was conducted on the Motion at which the parties submitted a joint stipulation of facts and presented legal arguments. After the parties disclosed the paucity of authorities addressing the issues raised by the Motion, the Court took the matter under advisement so as to give the Court the opportunity to conduct its own inquiry into these issues.

## II. Findings of Fact.

The matter was submitted by the parties to the Court upon stipulated facts and exhibits. On May 9, 1997, the Bank loaned $50,000.00 to the Debtor[2] "for insurance and working capital"

[2]There is some confusion regarding the role of each debtor in this transaction. The promissory notes and the Security Agreements were executed by "William S. Hart d/b/a Hart General Contractors." The Certificate of Title to the Truck is issued to "William S. Hart." The Certificate of Title to the Trailer is issued to "Hart General Contractors." On the other hand, separate Chapter 7 petitions were filed for Hart General Contractors, Inc., as distinguished from William S. Hart, individually. However, the significance of this issue is now moot due to the entry of the substantive consolidation order.

(the "May 9th Note"). The loan agreement, admitted as "Exhibit P-1", clearly stated that it was a "closed-end credit" arrangement and that no future advances were contemplated by the parties. To secure the payment of the May 9th Note, the Debtor conveyed to the Bank a security interest in the Truck and Trailer. The Bank's security interest was properly perfected as evidenced by the notation of the lien on the respective Certificates of Title to the Truck and Trailer (Exhibit P-2).

On June 8, 1997, the Debtor paid the indebtedness created by the May 9th Note in full. Three days later, on June 11, Kelly M. Sanders, a duly authorized officer and agent of the Bank, executed and dated the respective Certificates of Title to the Truck and Trailer in the space entitled "First Lien Released", evidencing a release of the Bank's lien on the respective Property. However, the certificates of title were not then delivered to the Debtor, but rather remained in the Bank's possession, apparently in anticipation of future borrowing by the Debtor.

The Debtor did subsequently borrow $25,000.00 from the Bank on or about June 25, 1997 (the June 25th Note) and executed a new note and security agreement granting to the Bank a new security interest in the Truck and Trailer. However, no new Certificate of Title was issued on either the Truck or the Trailer, reflecting that a new lien had been granted. The Bank simply continued to hold the respective Certificates of Title which it had possessed since the inception of the May 9th Note, despite the fact that the May 9th Note had been paid in full and the lien granted in that transaction had been released. Though the balance of the June 25th Note was subsequently reduced through a series of partial payments and renewals, the Debtor still owed an indebtedness of $17,995.04 to the Bank at the time that the Debtor filed its Chapter 7 petition.

Thus, at the time of the filing of the Chapter 7 petition, the respective Certificates of Title to the Truck and Trailer through which the Bank asserts a perfected security interest in the

Property were still in the Bank's possession, but reflected a release of the first lien as of June 11, 1997. No claim of exemption has been made against the Truck and Trailer by the individual debtor in this matter and the parties have stipulated that, if a perfected lien exists, there is no equity in the Property which would inure to the benefit of the Trustee and, ultimately, the unsecured creditors in this case.

## III. Conclusions of Law.

It is undisputed that the Debtor, as a part of the May 9th loan transaction as well as the transaction for the June 25th Note, granted to the Bank a security interest in the Truck and Trailer. In order to prevail against the interests of the Trustee, however, thereby establishing its right to foreclose upon the Property, the Bank must demonstrate that its security interests in the Property were properly perfected prior to the filing of the Chapter 7 case.

The perfection of a security interest in a motor vehicle[3] under Texas law is governed by the Texas Certificate of Title Act, now codified under Chapter 501 of the Texas Transportation Code [TEX. TRANSP. CODE §501.001-501.159]. Specifically, §501.111 of the Transportation Code provides that, except as to motor vehicles held as inventory by a seller of such vehicles, a security interest in a motor vehicle can be perfected "only by recording the security interest on

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[3]The Truck & Trailer would both qualify as a "motor vehicle" subject to the Certificate of Title Act under the definition provided by §501.002(14) which states, in relevant part, that: "Motor vehicle" means:

(A) any motor driven or propelled vehicle required to be registered under the laws of this state;
(B) a trailer or semitrailer, other than manufactured housing, that has a gross vehicle weight that exceeds 4,000 pounds."

The Certificate of Title to the Trailer (Exhibit P-2) reveals a weight of 10,600 pounds.

the certificate of title as provided by this chapter."[4] The Certificate of Title Act further provides that a lien is deemed recorded "when the county assessor-collector either is presented with an application for a certificate of title that discloses the lien with the tender of the filing fee" or he otherwise accepts the application. TEX. TRANSP. CODE §501.113(a).

Though the codification of the Texas Certificate of Title Act into the Transportation Code is a relatively recent occurrence, the Certificate of Title Act has been in existence in Texas since 1939 and, since its inception, has been the exclusive procedure for the perfection of security interests in motor vehicles. *See, e.g.,* ***Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co.,*** 465 S.W.2d 933, 937 (Tex. 1971) ["Under the law of this state a lien may not be enforced against an innocent purchaser unless it is noted on the Texas certificate of title."]; ***Higgins v. Robertson***, 210 S.W.2d 250, 253 (Tex. Civ. App.- Amarillo, 1948, writ ref'd n.r.e.) ["...the certificate of title act repealed and superseded those parts of chattel mortgage registration statutes previously enacted insofar as they affected the registration of chattel mortgage liens on automobiles...and no valid lien could be asserted against an automobile unless it is disclosed by a valid certificate of title regularly issued by the Department of Public Safety, even though an asserted lien has been previously filed in the office of the County Clerk as provided by other chattel mortgage registration statutes."]

Of course, the Bank is charged with knowledge of this procedure for the perfection of security interests in motor vehicles and the Bank demonstrated in this very case that it had actual

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[4] §9.302(c)(2) of the Texas Business and Commerce Code confirms this procedure by stating, in relevant part, that the filing of an Article 9 financing statement "is not necessary nor effective" to perfect a security interest in property subject to Chapter 501 of the Transportation Code.

knowledge of the required procedure since it precisely followed that procedure in perfecting its security interest in the Truck and Trailer in May, 1997 to secure the payment of the indebtedness incurred by the Debtor under the May 9th Note.

Yet, beyond that point, the Bank's compliance with the designated perfection procedure ceases. The Certificate of Title Act mandates that a lienholder execute and deliver a release of lien to an owner once the underlying indebtedness has been paid.[5] The release was timely executed, but admittedly never delivered. Although the Debtor had extinguished all indebtedness to the Bank, the Bank simply maintained private possession of the original certificates of title to the Truck and Trailer, respectively, in the interim period until the June 25th Note was executed by the Debtor, although any inspection of such certificates would have clearly revealed that the Bank had released its respective liens on June 11th. After the June 25th Note was signed, the Bank never took any further action to perfect a new lien on either vehicle. Thus, the security interests granted to the Bank by the Debtor in the June 25th loan transaction were never separately perfected. This inaction by the Bank regarding perfection continued until and beyond the time that the Debtor filed for Chapter 7 relief.

Upon the filing of a petition for relief under Chapter 7 of the Bankruptcy Code, a bankruptcy estate is created[6] and a Chapter 7 trustee is appointed.[7] In order to maximize the

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[5] TEX. TRANSP. CODE §501.115(a) provides, in part, that "when a debt or claim secured by a lien has been satisfied, the lienholder shall, within a reasonable time not to exceed 21 days from receipt of the final payment, execute and deliver to the owner, or the owner's designee, a discharge of the lien on a form prescribed by the department." (emphasis added).

[6] 11 U.S.C. §541(a).

[7] 11 U.S.C. §701(a).

assets from which cash distributions will ultimately be made to creditors, the Bankruptcy Code endows a Chapter 7 trustee with certain rights and powers. Included among those powers is the status granted to a trustee under §544(a) of the Code. Section 544(a) provides that the trustee is granted, automatically and without notice as of the petition date, and without regard to any knowledge which he or any creditor may actually possess, the powers which state law would confer upon a hypothetical creditor of the debtor who had perfected a judicial lien on all of the debtor's property. *See generally*, **5** COLLIER ON BANKRUPTCY ¶ 544.05 at pp. 544-9 and 544-10 (15th ed. rev. 1999). This power is significant because "if the holder of a security interest in the debtor's property has not taken the necessary steps under applicable law to put other potential creditors on notice of its interest by proper perfection, .... the Uniform Commercial Code provides that such a security interest is subordinate to the rights of a judicial lien creditor." [8] ***Id.*** at p. 544-10. The Fifth Circuit acknowledged this significant trustee benefit in its application of Texas law in ***In re McBee***, 714 F.2d 1316 (5th Cir. 1983) in which it observed that:

> [I]n assessing whether a security interest may validly attach to assets of the estate in bankruptcy, the trustee is considered to be a hypothetical lien creditor. Unless a creditor's interest is perfected, as against the trustee in this hypothetical position, its asserted interest in collateral is not effective. ***Id.*** at 1321.

Thus, an alacritous analysis of the fact scenario presented by this case would appear to lead one to a rather obvious conclusion that the Bank stands unperfected and that the Trustee would therefore prevail in a battle of priorities due to the provisions of §544(a). However, the Bank asserts that its interests should be deemed perfected under the peculiar circumstances of

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[8]This is the result under Texas' adoption of the Uniform Commercial Code. TEX. BUS. & COMM. CODE §9.301(a)(2).

this case, notwithstanding its admission that the previous liens were released and that the new liens arising from the June 25th loan transaction were never separately perfected under the Certificate of Title Act.

The Bank first states that the liens on the Property were never released since there was never any delivery of the certificates of title by the Bank to the Debtor evidencing the release of the liens. This argument has no support in Texas law. "A lien is but an accessory to, or mere incident of, the debt secured by it, and is discharged and extinguished, ipso facto et eo instante, by payment of the debt by the person primarily obligated by contract therefore." ***Shipley v. Biscamp***, 580 S.W.2d 52, 54 (Tex. Civ. App. - Houston [14th Dist.] 1979, no writ); ***Green v. Am. Nat'l Ins. Co.***, 452 S.W.2d 1, 4 (Tex. Civ. App.- San Antonio 1970, no writ). Put simply, for at least 140 years, Texas jurisprudence has declared that, without a debt, there can be no lien, ***Perkins v. Sterne***, 23 Tex. 561 (1859), and the Bank's breach of its duty to deliver the release to the Debtor under TEX. TRANSP. CODE §501.115(a) cannot manufacture a different result.

Alternatively, the Bank asserts that its liens arising from the June 25th loan transaction should still be considered as properly perfected because their liens were already noted on the certificates of title; thus, the Bank had already taken all of the steps necessary for perfection of the security interest eventually granted on June 25th. This so-called "springing perfection" arises in Texas under the provisions of TEX. BUS. & COMM. CODE §9.303(a)[9] which provides that, if all

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[9]§9.303(a) provides that:
A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in Sections 9.115, 9.302, 9.304, 9.305, and 9.306. If such steps are taken before the security interest attaches, it is perfected at the time when it attaches.

the steps to perfection of a security interest have been taken before the time that a security interest actually attaches, the security interest becomes immediately perfected upon attachment.

The Bank acknowledges that the Certificate of Title Act governs perfection of an interest in a motor vehicle in Texas and that the Act has no corresponding or equivalent section to §9.303(a) in its provisions. Yet the Bank asserts that, since the UCC still governs the creation of security interests in vehicles and merely defers to the Transportation Code for perfection provisions, this Court should, in recognizing that the UCC contemplates the availability of such flexible perfection rules[10], take a holistic approach to this issue by applying the "springing perfection" concept to motor vehicles, even though the statutes in the Transportation Code do not specifically endorse it. The Bank urges the adoption of this approach, even though the Bank can cite no case authority endorsing it.[11]

Even if there were case authority to support the Bank's position, this Court would not be inclined to follow it, since it would allow the Bank to profit from its own intentional failure to

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[10]The Bank also references the fact that a secured party need not file a termination statement under §9.404, terminating the effect of a UCC financing statement, when the parties are contemplating future advances. Although the parties in this case likely did contemplate future transactions, there is no such corresponding provisions in the Texas Certificate of Title Act for lenders in a motor vehicle context.

[11]The Bank cited the Court to only one case — ***In re Fleming***, 226 B.R. 3 (Bankr. W.D. Mich. 1998) — which holds that, under Michigan law, a lender who refinances an automobile loan and secures the new debt with the same vehicle that secured the original debt is not required to file a termination statement and an application for new title, but rather may rely on the existing certificate of title which noted its security interest. The ***Fleming*** case is obviously distinguishable since that involved a novation process under which there was always an underlying obligation owing to the bank. It is interesting to note, however, that, under the facts in the present case, in which the Bank had made no commitment to make a loan to the Debtor, but merely expected the Debtor to request additional advances in the future, the provisions of the Michigan Vehicle Code as applied in ***Fleming*** would preclude any "springing perfection" of the Bank's liens.

act in accordance with the designated statutory procedures. Though perhaps cumbersome, the Bank had a clear duty under §501.115(a) to release the liens upon payment of the indebtedness, to deliver such releases to the Debtor, and to repeat the perfection process in the event the Bank chose to lend more money to the Debtor in the future.

The Bank argues that to require such strict compliance with those procedures in order to preserve perfection of a security interest in a motor vehicle is impractical, particularly when successive transactions are anticipated with a borrower who repeatedly utilizes the same vehicles as collateral. The Bank essentially argues "no harm, no foul." New indebtedness arose within seventeen days. No one knew that the liens had been released anyway. Therefore, in the Bank's eyes, since no party could have discovered in the interim period that the Bank was not actually owed any money and thus could not possess a security interest in any of the Debtor's property, no harm could have occurred and the Bank's shortcut around the hyper-technical perfection requirements should be permitted.

But this Court will not legitimize the Bank's misconduct by endorsing such an abridged process which encourages deception and misinformation. Apart from allowing the Bank to benefit from its own wrongful refusal to abide by the enacted statutory procedure, an endorsement of the Bank's stealth perfection process places into the hands of a party, who has already been paid in full, the unilateral and unbridled discretion to vault back into a senior lien position as to previously-released collateral at some undetermined time in the future. How long should we allow a secured party to hibernate? How long should a lender be able to forestall the delivery of a release of lien to an owner of property in order to "preserve" its right to return to a perfected senior lien position upon the incurrence of new indebtedness?

These issues are not insurmountable, as §9.303(a) demonstrates, and the legislature is certainly free to introduce them into Texas commercial transactions involving motor vehicle financing. However, they should not be abruptly imposed by judicial fiat. The legislature apparently prefers the certainty arising from an arguably more cumbersome process over the uncertainty which would arise from a more subjective process. The Bank may not agree with that preference. It may find the Texas perfection requirements as to security interests in vehicles to be burdensome and impractical, especially when dealing with a recurring customer such as the debtor in this case, but this Court is not the proper venue for the advocacy of that preference.

This Court must apply, and the Bank must abide by, the law as it is. Perhaps the Bank has successfully utilized this informal procedure with other clients and escaped unscathed. Such a fortuitous circumstance is possible, perhaps likely. But its luck ran out in this case. Although its customer's bankruptcy filing did not occur until well over a year after the parties reestablished a debtor-creditor relationship, the Bank failed to take any action in that substantial period of time to perfect its liens in the manner mandated by state law. While it may still believe that its conduct was justified, the Bank simply must recognize that, whenever it unilaterally elects to ignore the sanctioned procedure for perfecting its liens in motor vehicles, it does so at its peril, and it should not look to any court to provide an escape hatch from the consequences of its own miscalculations. As the Texas Court of Civil Appeals said over fifty years ago,

> A reasonable interpretation of the Act and common prudence make it the duty of a lien holder to see that the mortgagor has complied with the State Certificate of Title law in order to protect his lien as well as to protect innocent purchasers. If the lien holder is derelict in his duty, he suffers the consequences as a result of his own negligence.

***Higgins v. Robertson***, 210 S.W.2d 250, 253 (Tex. Civ. App.- Amarillo, 1948, writ ref'd n.r.e.)

The same difficult lesson applies today. The Court holds that the Bank's misjudgments renders its security interests in the Truck and Trailer unperfected as of the date of the entry of the order for relief in this case. Therefore, the rights and interests of the Chapter 7 Trustee in such Property as a hypothetical lien creditor under 11 U.S.C. §544 are superior to that of the Bank and precludes any finding of cause for granting the Bank's motion for relief from stay. Accordingly, the Bank's motion for relief from stay filed in the above-referenced consolidated Chapter 7 case is denied and the Court will prepare and enter a separate order memorializing that ruling.

SIGNED this the 27th day of April, 1999.

BILL PARKER
UNITED STATES BANKRUPTCY JUDGE

cc: **Scott Ritcheson, Atty for Citizens State Bank, 3301 Golden Rd. #400, Tyler, TX 75701**
**Bob Anderson, Chapter 7 Trustee, P. O. Box 3343, Longview, TX 75606**