

An Overlooked Niche of Consumer Law

CAR TITLE DISPUTES

Arising Out of Sales Out of Trust



By Richard Tomlinson*

In the typical automobile sales transaction, there are a number of parties that serve particular roles. First, a floorplanner is a lender that provides financing for the dealer to put the automobile for sale on the lot, which is secured by a purchase money security interest (hereinafter "PMSI") in the dealer's inventory. Second, the dealer who offers to sell the vehicle. Third, the consumer who agrees to purchase the vehicle from dealer's lot. Finally, the retail finance source provides the funding for the consumer to purchase the automobile from the dealer, secured by a PMSI in the vehicle which is the subject of the sale. This retail financing usually comes in one of two forms, direct or indirect financing. Direct financing is when the retail lender deals directly with the consumer, whereas indirect financing occurs when the retail lender purchases a retail installment contract executed by the dealer and the consumer.

The issue that arises when all of these parties do not properly play their respective roles is, what happens when a vehicle is sold by a dealer without payment of the floorplanner's PMSI? This is commonly known as a "sale out of trust." Such sales out of trust are very common, especially with failing used car dealers. The law must determine who must suffer or share the risk of loss when such a sale out of trust occurs. This article endeavors to survey how the law has addressed the burden of risk in sales out of trust and, thereby, to give consumer advocates the tools to identify those cases which are worth handling.

A. Background of sales out of trust

Many dealers need financing to purchase their inventory of automobiles, whether they are offering new or used cars. When dealers need such financing they usually

sign floorplan agreements with their lenders. New car dealers frequently obtain this financing from the finance subsidiaries of the manufacturers, such as GMAC or Ford Motor Credit. With used car dealers such financing may come from a local bank or an individual or group of individuals. Under these floorplan agreements dealers receive funds from the lender to purchase new cars from a manufacturer or used cars from a wholesale source, such as an auction or another dealer. In return for providing a line of credit to purchase inventory, the dealer agrees to grant a security interest to the floorplanner on their entire inventory. In practice, when a floorplanned vehicle is sold off the dealer's lot, the dealer is obligated to use the proceeds to pay off the principal and interest owed to its floorplanner first, leaving any remainder as its gross profit. To further protect themselves, floorplanners will commonly retain possession of the titles or manufacturer's certificates of origin to automobiles purchased with their credit by the dealer until the money that they have advanced to the dealer, together with interest or other applicable fees, is paid off by the dealer.

Occasionally, dealers (especially used car dealers) sell floorplanned vehicles to consumers by execution of a retail installment contract, receive a payment from a finance company for the sale and assignment of the contract, and then fail to use these proceeds to pay their floorplanner. The reasons for the dealer's failure to pay the floorplanner can include anything from excessive spending on personal items and payments to other demanding creditors, to simple business incompetence. What is a floorplanner to do? At a minimum, the injured floorplanner will usually refuse to release the title it retains as security. More assertive floorplanners arrange for the repossession of the floorplanned vehicle from the innocent

consumer-buyer. Even when a consumer does not find the automobile repossessed in the middle of the night by the floorplanner, the dealer's failure to obtain title and registration for the consumer will prevent the consumer from lawfully operating the vehicle. In effect, floorplanners usually try to assert that the consumer and retail finance entity that financed the sale should bear the entire risk of loss from the dealer's failure to pay.

To obtain a license to sell vehicles, used car dealers are required to have a \$25,000 bond in place to cover damages incurred by buyers and others when title does not pass correctly.¹ As currently construed, this law permits consumers, retail finance entities and wholesalers to sue dealers who are often defunct, obtain judgments, and then recover the amount of these judgments against the applicable dealer bond of \$25,000.² Interestingly enough, floorplanners would usually have no claim to recovery under the bond.³

Problems frequently arise because the \$25,000 bond will usually only cover the loss associated with one or two automobiles. The bond also only covers claims occurring during the 12-month term of the bond that have been reduced to judgment. These bonds are sureties which most often pay claims in order of presentment. Thus, the surety bond is paid on a first-come-first-serve basis with the first claimant recovering up to the amount of the \$25,000 face value of the bond, reducing the value, while each subsequent claim reduces the value of the bond until fully depleted. When a dealer sells out of trust, however, it is common for the dealer to sell a whole raft of vehicles out of trust before it is discovered. When the minimal dealer bond is not enough to cover the potential loss, the question of who bears the risk of loss must be addressed squarely. Unfortunately, in these circumstances, the law in Texas is not clear on the placement of the risk of loss.

B. Who should bear the risk of loss?

The floorplanner, who holds the position that the consumer and retail finance entity should bear the full risk of the loss, will usually argue that the purported sale of the vehicle to the consumer by the dealer was void due to the failure of the dealer to possess title or to transfer title at the time of sale. Floorplanners rely specifically on the Texas Transportation Code (hereinafter "Transportation Code"), and in particular the Certificate of Title Act (hereinafter "COTA").⁴ The Transportation Code § 501.071(a) provides that "[a] motor vehicle may not be the subject of a subsequent sale unless the owner designated on the certificate of title transfers the certificate of title at the time of sale."⁵ In addition, Transportation Code § 501.152 provides that it is an offense to sell or offer to sell a motor vehicle registered in this state when the seller "does not possess the title receipt or certificate of title for the vehicle."⁶ Thus, since the Transportation Code, § 501.073 provides that "[a] sale made in violation of this chapter is void and title may not pass . . .,"⁷ floorplanners argue that no title passes when they are holding the title and the dealer did not transfer title at the time of the purported sale.

In a number of cases where floorplanners, wholesalers and other sellers were paid with drafts that bounced, several Texas appellate courts have accepted this COTA argument and have found subsequent sales by dealers to be void.⁸ What does this mean in practice? The floorplanner retains title, is entitled to possession of the vehicle sold out of trust, and the innocent consumer must bear the entire risk of loss. The practical result

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places every consumer in peril. Giving legal significance to the mere possession of a certificate of title provides the floorplanning lender the best of both worlds by permitting its inventory collateral to be exposed for sale to the public from which proceeds are generated for the dealer to pay the secured debt, and empowering that lender to render void, retroactively, any sale of which it does not approve.

1. Agency Exception

In an effort to ameliorate the harshness of this COTA rule, other courts have found an exception based on an agency relationship between the dealer and the floorplanner. Initially, these courts cite to the recognized rule that a sale of an automobile may still be valid as between a buyer and a seller despite non-compliance with COTA.⁹ If proven that the dealer was acting as the agent of the floorplanner in selling the vehicle, a number of courts have recognized that the innocent consumer who purchased from the dealer is entitled to retain possession and to receive title, even if

COTA was violated in the process.¹⁰ These courts recognize that if the dealer as agent of the floorplanner was authorized to sell a vehicle to the buyer, the sale would be effective as between the floorplanner (the actual seller) and the buyer.¹¹ Under these circumstances, the floorplanner would bear the risk of loss associated with its own agent's faithlessness.¹² In other words, the floorplanner would bear the loss of the money that the dealer failed to pass on to the floorplanner following the sale.

This agency exception to the general rule requiring compliance with COTA does not always provide protection to innocent consumers. For example, in *Morey v. Page*, the Dallas Court of Appeals found inadequate evidence of the agency relationship.¹³ In that case, Page consigned a 1967 Bentley for sale by Yardley under the stipulation that he recover a \$20,000 net profit. Yardley negotiated the sale of the Bentley to Morey for only \$9,000, and Yardley absconded with these funds. The Dallas Court of Appeals found no express authority for the sale due to the failure to meet the consignment condition of a \$20,000 net return and no apparent authority due to the fact that Yardley never disclosed that he was acting on behalf of Page.¹⁴ Given the fact that the strength of the evidence in favor of agency will vary greatly between different cases, this exception provides at best an uncertain lifeline to innocent purchasers. If the innocent purchaser is buying from a licensed dealer, in a transaction that has the appearance of a sale in the ordinary course of the dealer's business, why should the validity of the sale be dependent upon a prior transaction between the dealer and an undisclosed principal? The Texas Uniform Commercial Code¹⁵ (hereinafter "U.C.C.") provides rules of priority that protect buyers in the ordinary course of business in such circumstances.

2. U.C.C. alternative

If the U.C.C. applies in the context of a sale out of trust by a dealer, an innocent purchaser would be accorded title and the risk of loss associated with the dealer's defalcation would be placed squarely upon the floorplanner. In a majority of the states, the U.C.C. prevails over the applicable COTA in cases involving out of trust sales.¹⁶ Interestingly enough, the Transportation Code specifically provides that it is to yield to the U.C.C. where there is a conflict between these two bodies

of law.¹⁷ Several Texas courts have recognized the U.C.C. as an alternative source of law, which unlike the COTA rule and the agency exception, provides a bright line rule.

Based on the U.C.C., innocent buyers are entitled to receive title in “out of trust” sales under one of two theories. The first theory involves the Texas Business and Commerce Code (hereinafter “U.C.C.”) § 2.403(a) which states that a person “with voidable title has power to transfer a good title to a good faith purchaser for value,” and “[w]hen goods have been delivered under a transaction of purchase the purchaser has such power even though . . . the delivery was in exchange for a check which is later dishonored . . . or the delivery was procured through fraud punishable as larcenous under the criminal law.”¹⁸ In effect, the courts construing these provisions have held that a purchaser who procured a good, such as a vehicle, with a check or draft that was dishonored nevertheless had voidable title to pass and that a good faith buyer from such a fraudulent purchaser was entitled to receive title.¹⁹

The second theory involves the U.C.C. § 2.403(b) which provides that the “entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in the ordinary course of business.”²⁰ In addition, U.C.C. § 1.201(9) states a “‘buyer in the ordinary course of business’ means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker.”²¹ Under U.C.C. section 2.401(b), title to goods passes when the seller completes physical delivery of the goods, even if a document of title is to be delivered at a different time and place.²² These statutes together make a strong argument that title passes from the seller to the buyer regardless of the security interest of a third party who places their interest in risk when entrusting their goods to a merchant.

Under an amendment to COTA passed in 1971 and intended to be a reversal of the ruling in *Phil Phillips*²³ on the inapplicability of the U.C.C. to automobile title issues, the provisions of the U.C.C. are supposed to prevail over COTA in the event of any conflict.²⁴ This amendment should have established that U.C.C. §§ 2.401 and 2.403 control over the COTA’s provisions which purport to void the sale of an automobile absent possession of title by the seller at the time of sale or absent a transfer of title at the time of sale.²⁵

While the conflict between the U.C.C. good faith buyer provisions and the COTA is clear, the Dallas Court of Appeals and a few other courts have attempted to “harmonize” the statutes and thereby avoid the resulting U.C.C. control in the event of a conflict.²⁶ The existence of a conflict between sections 2.401 and 2.403 of the U.C.C. and COTA is clear, and the U.C.C. should govern title disputes arising from “out of trust” sales. The Tyler Court of Appeals and the United States Bankruptcy Court for the Northern District of Texas have recognized this conflict and have given full effect to the U.C.C..²⁷ Likewise, two justices on the Dallas Court of Appeals have recognized the conflict and opined that U.C.C. § 2.403(b) should be given full effect.²⁸

3. Recent cases finding that COTA is inapplicable

On January 27, 2003, the U.S. District Court for the Southern District of Texas in *In re Dota*, concluded that a dealer was not an “owner” for purposes of Transportation Code section 501.071 which means the failure to transfer title did not render a sale from a dealer to a consumer invalid under Transportation Code § 501.073.²⁹ The court further held that neither the Transportation Code nor the U.C.C. permitted a

floorplanner to assert a security interest to a vehicle held as inventory by merely retaining possession of the title.³⁰ The court applied the U.C.C. finding that a cash buyer was a buyer in the ordinary course of business under U.C.C. § 1.201(9) and consequently free to take title to a vehicle, despite having failed to demand a transfer of title at the time of sale.³¹ This decision was appealed to the Fifth Circuit, but the appeal was dismissed on jurisdictional grounds.³²

More recently on August 27, 2004, the Texas Court of Appeals in Corpus Christi took a different track to rule for an innocent consumer buyer.³³ In *First National Bank of El Campo v. Buss*, concerning a classical sale “out of trust” transaction involving the same dealer as in the *In re Dota* case, this appellate court, unlike the Dallas Court of Appeals and the 5th Circuit Court of Appeals, found a conflict between the COTA and the U.C.C. and applied the U.C.C.³⁴ Finding the consumer to be a “buyer in the ordinary course of business,” the Court thereby affirmed the trial court’s finding that the consumer should receive title free of the bank’s inventory lien.³⁵ The bank defendant has filed a petition for review with the Texas Supreme Court, which has been pending since November 1, 2004.³⁶ Should the Texas Supreme Court decide to take the case, the issues raised in the foregoing cases will finally be resolved. How these issues will pan out before the current Texas Supreme Court is anyone’s guess.

Based on the *In re Dota* and *First National Bank of El Campo* rulings, COTA would never apply to cases involving dealers who made “out of trust” sales. Under *In re Dota*, there is no need to argue that there is a conflict between COTA and the U.C.C., so that the preemption provision in COTA becomes effective. By contrast, under *First National Bank of El Campo*, there is a conflict between COTA and the U.C.C. and this means that the U.C.C. prevails. In short, if the *In re Dota* and *First National Bank of El Campo* cases are followed, the bright line rule of the U.C.C. will apply to all “out of trust” cases involving automobile dealers, and the cases applying COTA to such issues in the past could be ignored. One can only hope this is where the law shakes out, as the U.C.C. provides a rule which is both more fair and more clear than COTA.

C. Conclusion

Even if *In re Dota* and *First National Bank of El Campo* are not followed in the future, practitioners should expect a change in the law nevertheless. The Conference on Uniform Laws is considering proposals for changes in the uniform COTA that would recognize the BFP rule now solely recognized in the U.C.C. Should such proposed amendments to our COTA be passed by the Texas Legislature, innocent consumer-purchasers will be protected, even if our courts fail to recognize that the U.C.C. should apply.

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1. TEX. TRANSP. CODE § 503.033 (2004).
2. *Old Republic Surety Company v. Reyes*, 2002 Tex. App. LEXIS 5649 (Tex. App. - Dallas 2002, pet. denied)(consumer); *Grammercy Ins. Co. v. Arcadia Financial*

- Ltd., 96 S.W.3d 320, 323-26 (Tex. App. - Austin 2001, *pet. denied*)(retail finance company); Grammercy Ins. Co. v. Auction Fin. Program, 52 S.W.3d 360, 363-68 (Tex. App.—Dallas 2001, *pet. denied*)(auction house); Grammercy Ins. Co. v. Arcadia Fin. Ltd., 32 S.W.3d 402, 407 (Tex. App.—Houston [14th Dist.] 2000, *no pet.*)(retail finance company); Lawyers Surety Co. v. Royal Chevrolet, 847 S.W.2d 624, 626-27 (Tex. App- Texarkana 1993, *no writ*) (wholesaler); Geters v. Eagle Ins. Co., 834 S.W.2d 49, 50 (Tex. 1992) (consumer).
3. Grammercy Ins. Co. v. MRD Investments, Inc., 47 S.W.3d 721, 727 (Tex. App. - Houston [14th Dist.] 2001, *pet. denied*); Lawyers Surety Corporation v. Riverbend Bank, 966 S.W.2d 182, 185-87 (Tex. App. - Fort Worth 1998, *no pet.*).
 4. TEX. TRANSP. CODE § 501.071 (2004).
 5. TEX. TRANSP. CODE § 501.071(a) (2004).
 6. TEX. TRANSP. CODE § 501.152 (2004).
 7. TEX. TRANSP. CODE § 501.073 (2004).
 8. Bank One Texas N.A. v. Arcadia Fin. Ltd., 219 F.3d 494, 497-98 (5th Cir. 2000); Allstate Ins. Co. v. Troy's Foreign Auto Parts, 2001 LEXIS 5029 (Tex. App.--Dallas 2001); Gallas v. Car Biz. Inc., 914 S.W.2d 592, 594-95 (Tex. App.—Dallas 1995, *pet. denied*); Everett v. United States Fire Ins. Co., 653 S.W.2d 948, 950 (Tex. App.--Fort Worth, *no writ*); Boswell v. Connell, 556 S.W.2d 624, 625-26 (Tex. Civ. App.—Beaumont 1977, *writ ref'd n.r.e.*).
 9. Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co., 465 S.W.2d 933, 937 (Tex. 1971); Hudson Buick, Pontiac, GMC Truck v. Gooch, 7 S.W.3d 191, 197 (Tex. App.—Tyler 1999, *pet. denied*); Tyler Car v. Empire Fire & Marine Ins. Co., 2 S.W.3d 482, 485 (Tex. App.--Tyler 1999, *pet. denied*); Jarrin v. Sam White Oldsmobile Co., 929 S.W.2d 21, 24 (Tex. App.--Houston [1st Dist.] 1996, *writ denied*); Najarian v. David Taylor Cadillac, 705 S.W.2d 809, 811-12 (Tex. App.—Houston [1st Dist.] 1986, *no writ*).
 10. Morey v. Page, 802 S.W.2d 779, 784 (Tex. App.—Dallas 1990, *no writ*); IFG Leasing Co. v. Ellis, 748 S.W.2d 564, 566 (Tex. App.—Houston [1st Dist.] 1988, *no writ*); Cash v. Lebowitz, 734 S.W.2d 396, 398 (Tex. App.--Dallas 1987, *writ ref'd n.r.e.*); Jim Stephenson Motor Co., Inc. v. Amundson, 711 S.W.2d 665, 669 (Tex. App.—Dallas 1986, *writ ref'd n.r.e.*); Pfluger v. Colquitt, 620 S.W.2d 739, 743 (Tex. Civ. App.—Dallas 1981, *writ ref'd n.r.e.*).
 11. Morey, 802 S.W.2d at 784.
 12. Cash, 734 S.W.2d at 399; Pfluger, 620 S.W.2d at 743.
 13. Morey, 802 S.W.2d at 799.
 14. Morey, 802 S.W.2d at 782-85.
 15. The Texas Uniform Commercial Code refers to TEX. BUS. & COM. CODE, Title 1, Ch. 1-9 enacted July 1, 2001.
 16. See, e.g., Madrid v. Bloomington Auto Co., Inc., 782 N.E.2d 386, 391-97 (Ind. App. 2003); Jones v. Mitchell, 816 So.2d 68, 69-72 (Ala. App. 2001); Cherry Creek Dodge, Inc. v. Carter, 733 P.2d 1024, 1027-29 (Wyo. 1987); Dartmouth Motor Sales, Inc. v. Wilcox, 517 A.2d 804, 806-07 (N.H. 1986); Big Knob Volunteer Fire Co. v. Lowe & Moyer Garage, Inc., 487 A.2d 953, 956-59 (Pa. Super. 1985); Atwood Chevrolet-Olds, Inc. v. Aberdeen Mun. School Dist., 431 So.2d 926, 927-29 (Miss. 1983); Martin v. Nager, 469 A.2d 519, 522-26 (N.J. Super. 1983); Roger D. Billings, FLOOR PLANNING, RETAIL FINANCING & LEASING IN THE AUTOMOBILE INDUSTRY §§ 5.36 - 5.41 (West 1998).
 17. TEX. TRANSP. CODE § 501.005 (2004).
 18. TEX. BUS. & COM. CODE § 2.403(a) (2004).
 19. Prestige Ford v. Dallas Postal Credit Union, 2002 Tex. App. LEXIS 974, * 11-13 (Tex. App.—Dallas 2002) (dishonored draft); Perry v. Breland, 16 S.W.3d 182, 190 (Tex. App.—Eastland 2000, *pet. denied*) (dishonored check); Villa v. Alvarado State Bank, 611 S.W.2d 483, 487-88 (Tex. App.—Waco 1981, *no writ*) (dishonored check); Leif Johnson Ford, Inc. v. Chase Nat'l Bank, 578 S.W.2d 792, 794 (Tex. Civ. App.—Beaumont 1978, *no writ*) (“Section 2.403(a) gives good faith purchasers of even fraudulent buyers-transferors greater rights than the defrauded seller can assert.”).
 20. TEX. BUS. & COM. CODE § 2.403(b) (2004).
 21. TEX. BUS. & COM. CODE § 1.201(9) (2004).
 22. TEX. BUS. & COM. CODE § 2.401(b) (2004).
 23. Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co., 465 S.W.2d 933, 937 (Tex. 1971).
 24. TEX. TRANSP. CODE § 501.005 (2004).
 25. TEX. BUS. & COM. CODE §§ 2.401, 2.403(a) (2004). Hudson Buick, Pontiac, GMC Truck v. Gooch, 7 S.W.3d 191, 198 (Tex. App.—Tyler 1999, *pet. denied*); *In re* Bailey Pontiac, Inc., 139 B.R. 629, 633 n.3 (Bankr. N.D. Tex. 1992).
 26. Gallas v. Car Biz. Inc., 914 S.W.2d 592, 594-95 (Tex. App.—Dallas 1995, *pet. denied*); Morey v. Page, 802 S.W.2d 779, 783-84 (Tex. App.—Dallas 1990, *no writ*); Everett v. U.S. Fire Ins. Co., 653 S.W.2d 948, 950 (Tex. App.—Fort Worth 1983, *no writ*); Pfluger v. Colquitt, 620 S.W.2d 739, 741-42 (Tex. Civ. App.—Dallas 1981, *writ ref'd n.r.e.*); Bank One Texas N.A. v. Arcadia Fin. Ltd., 219 F.3d 494, 497 (5th Cir. 2000).
 27. *Hudson Buick*, 7 S.W.3d at 198; *In re* Bailey Pontiac, Inc., 139 B.R. at 633 n. 3.
 28. TEX. BUS. & COM. CODE § 2.403 (2004), provides: “(b) Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business.” *Gallas*, 914 S.W.2d at 595-601 (Wright, J., dissenting); *Pfluger*, 620 S.W.2d at 744-48 (Stephens, J., concurring).
 29. *In re* Dota, 288 B.R. 448, 455-58 (S.D. Tex. 2003).
 30. *Id.* at 458-60.
 31. *Id.* at 460-61.
 32. *Id.*
 33. First Nat'l Bank of El Campo v. Buss, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, *pet. pending*).
 34. *Id.*
 35. *Id.*
 36. *Id.*