

**In re SKAGIT PACIFIC CORP.
316 B.R. 330 (9th Cir. BAP 2004)**

MARLAR, Bankruptcy Judge.

.... The secured creditor ... appeals the bankruptcy court's denial of a security interest in vehicles whose titles were never changed to reflect its liens....

FACTS

Skagit Pacific Corporation ("Debtor" or "Skagit") manufactures and sells modular offices and trailers.

Skagit executed promissory notes, secured by certain property of the Debtor, in favor of Frontier Bank. The notes were personally guaranteed by Douglas Peterson, president of Skagit, and his wife, Jean ("the Petersons"). Skagit subsequently delivered, on the demand of Frontier Bank, the titles to 10 vehicles and trailers. Frontier Bank took possession of the titles but did not change the name on the certificate of title, nor did it have its lien placed thereon as required to perfect under Washington law.

In October 2002, Skagit defaulted on the note obligations to Frontier Bank and the bank sued the Debtor and the Petersons in state court. Skagit filed for chapter 11 bankruptcy protection on December 11, 2002.

In February or March 2003, the Petersons settled their portion of the Frontier Bank lawsuit. As part of the settlement, the Petersons took an assignment of Frontier Bank's secured position with respect to Skagit, including the notes and security agreements. Frontier Bank also delivered the vehicle titles to the Petersons. The Petersons formed Frontier Asset Management LLC ("FAM") to hold and manage the interests purchased from Frontier Bank.

The parties agree that Frontier Bank held a valid and enforceable pre-petition security interest in owned or after-acquired equipment, inventory, accounts receivable, chattel paper, general intangibles, and all proceeds of such collateral; and, that the assignment to the Petersons was adequate. The parties also agree that FAM holds whatever interest Frontier Bank had in the titled vehicles.

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III. TITLED VEHICLES

FAM appeals the bankruptcy court's conclusion that FAM did not have a perfected security interest in 10 titled vehicles and trailers.

The nature, validity and perfection of security interests are determined by state law. *Butner v. U.S.*, 440 U.S. 48, 55 (1979). Generally, Washington law requires a certificate of

ownership, which lists the secured party, in order to perfect a security interest in a vehicle. RCW § 46.12.095.¹⁰ However, an exception is made for manufacturers and dealers who hold vehicles or equipment in inventory.

Frontier Bank did not follow the perfection procedures under RCW § 46.12 by applying to the Washington Department of Licensing to have its name placed on the certificate of title. And, Frontier Bank is not a manufacturer or dealer holding equipment in inventory. Therefore, Frontier Bank (and subsequently FAM) did not have a perfected security interest in the vehicles.¹¹

Nevertheless, FAM argues it has a security interest because (1) the vehicles were not used and were internally classified as “surplus” inventory; and (2) the titles were entrusted to FAM who held the titles in possession and therefore, ownership was transferred by operation of the UCC.

FAM asserts the equipment is unused and, as such, has become surplus inventory, held for sale. If the vehicles are inventory of a dealer, perfection may be accomplished by filing a financing statement; otherwise, the security interest may be perfected only by obtaining a certificate of ownership for the vehicle which lists the secured party. *In re Babaeian Transp. Co.*, 206 B.R. 536, 542 (Bankr. C.D. Cal. 1997); RCW § 62A.9A-311(d) (inapplicability of certificate of title requirements to those in the business of vehicles subject to the certificate of title statutes).

FAM has not cited any authority supporting its contention that lack of use of collateral changes its characterization. While the UCC allows the *use* of the collateral rather than its intrinsic nature to determine its classification for perfection purposes, it is the debtor’s intended use at the time of purchase that controls if the actual use and the intended use are in conflict. *McGehee v. Exch. Bank & Trust Co.*, 561 S.W.2d 926, 930 (Tex. Civ. App. 1978). In the Petersons’ declarations, they repeatedly refer to the vehicles as equipment, *see* RCW § 62A.9A-102(33), not inventory, *see* RCW § 62A.9A-102(48) Neither Frontier Bank nor FAM are in the business of selling equipment/vehicles of the kind at issue here. *See* UCC § 2-104(1), RCW

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A security interest in a vehicle other than one held as inventory by a manufacturer or a dealer and for which a certificate of ownership is required is perfected only by compliance with the requirements of RCW § 46.12.103 [requiring party to submit a transitional ownership record to the Department of Motor Vehicles listing the name and address of the security interest holder].... A security interest is perfected by the department’s receipt of ... the existing certificate, if any, and an application for a certificate of ownership containing the name and address of the secured party, and tender of the required fee.... A security interest is perfected as of the time of its creation if the secured party’s name and address appear on the outstanding certificate of ownership.

RCW § 46.12.095(1), (2).

¹¹ Frontier Bank did not assign any interest in the titles to FAM. Rather, it merely delivered the titles it had in its possession to FAM.

§ 62A.9A-311(d). Therefore, the exemption for holding vehicles in inventory does not apply to FAM.

FAM also relies on a theory of entrustment to provide a perfected security interest. The entrustment doctrine is set forth in Article 2 of the UCC, RCW § 62A.2-403, and provides that entrusting goods to merchants who deal in goods of the kind gives the merchant power to transfer all rights of the entruster. FAM argues that, under the entrustment principle, title to a vehicle may pass upon delivery and the failure to comply with the certificate statutes does not render the transaction void. *See Heinrich v. Titus-Will Sales, Inc.*, 868 P.2d 169 (Wash. Ct. App. 1994). This argument is without merit (and would otherwise only go to passage of title, not the perfection of liens on titled vehicles). The Debtor is not a merchant who deals in goods of the kind (equipment) who has been entrusted with the vehicles. Furthermore, the UCC does not govern perfection of certain assets that are subject to state certification of title laws. *See RCW § 62A.9A-102(a)(10)*. Therefore, any argument based on other sections of the UCC will not, contrary to the assertion made by FAM, trump state law licensing requirements for perfection as to titled vehicles.

A security interest in the vehicles was never properly perfected by Frontier Bank. Therefore, we AFFIRM the bankruptcy court's decision which denied FAM a security interest in the vehicles.

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