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## **STRUCTURE AND ADVANTAGES OF A MOTOR VEHICLE TITLING TRUST PROGRAM**

### **PURPOSE OF THE TRUST PROGRAM**

This article addresses the structure and advantages of a titling trust program used to facilitate the syndication of true leases involving certificate of title motor vehicles. If certificate of title motor vehicles are acquired and titled in the name of an equipment finance company, a subsequent syndication of that lease financing, which would include a transfer of legal title to the motor vehicle, would involve a significant administrative burden and expense. In addition to filing the paperwork and paying the administrative fee to transfer title, many states impose an excise, sales or transfer tax in connection with the transfer of title to a motor vehicle. The purpose of using a titling trust is to avoid having to transfer legal title, which permits the equipment finance company to avoid the administrative burden and not only the filing fee but also the excise, sales or transfer tax.

### **CREATING THE TRUST**

The first step to establishing a titling trust program is to create the trust. We recommend using a statutory trust (as opposed to a common law trust) since an advantage of the statutory trust is that one or more sub-trusts may be created within the umbrella of the master trust and assets held by the Trust may be allocated into those sub-trusts. Under a common law trust, there is no flexibility to create sub-trusts within the umbrella of the master trust.

Although a number of states have adopted statutory trust provisions, Delaware is on the leading edge and has the longest history of successfully using the statutory trust model. Also, under the Delaware statute, assets allocated to a sub-trust are insulated from exposure to liability of creditors of other sub-trusts or of the general trust.

(a) The Trust would be the lessor under the Lease, holding all rights and obligations of the lessor under the Lease; and all equipment would be acquired and owned by the Trust. It should be noted that the titling trust program may include general equipment, as well as certificate of title motor vehicles. There is no particular advantage to the equipment finance company to include in the titling trust program general equipment (that is, not certificate of title motor vehicles), but there is no reason that it could not be included for ease of administration of leasing activities. To the extent that the equipment acquired constitutes certificate of title motor vehicles, those motor vehicles would be titled in the name of the Trust and the Trust would be designated as the registered owner on the certificate of title with respect to that portion of the Equipment comprised of motor vehicles.

(b) The Trust is structured as a nominee or grantor trust for purposes of the Internal Revenue Code and should be a pass-through entity for purposes of Federal income tax, so that for

tax purposes all benefits and burdens of ownership of the Equipment would be held by the beneficiaries of the Trust, including all income tax ramifications.

(c) To create the trust, the equipment finance company and the Delaware financial institution intended to serve as the trustee negotiate and execute a Trust Agreement, and a Certificate of Trust is executed and filed with the statutory authorities in Delaware. The Trust, as a statutory trust, is a separate legal entity to the same extent as a corporation or limited liability company.

(d) The Trust is a separate legal entity which must qualify to transact business in each jurisdiction to the same extent that any other equipment finance company would be required to qualify by reason of the laws of the individual state and the scope and extent of the equipment finance company's activities in that state. Qualification to transact business will subject the Trust to record-keeping and reporting requirements with respect to the individual states, including preparation and filing of annual tax reports and returns for each state in which the Trust is qualified.

(e) In some states, the owner and lessor of Equipment is required to be separately licensed. In those states in which such separate licensure is required, the Trust would be required to obtain such a license. The Servicer would actually prepare and file the application, and any annual reports, required for such a license.

(f) The Trust, as lessor, would cause to be prepared and filed sales/use/rental/personal property tax reports and returns, and cause those taxes to be collected and paid.

Role of the Servicer. The role of the Servicer is to perform the administrative obligations of the Trust. Generally, the equipment finance company or, occasionally, a third party servicer, would enter into a Servicing Agreement with the Trust, and the Servicer would handle the administrative obligations of the Trust, including handling the qualification of the Trust to transact business; obtaining any required state licenses; and preparing and filing the annual tax reports and returns required to be filed by the Trust. The Servicer would actually prepare, file and remit the tax returns and taxes on behalf of the Trust. We generally provide for the Servicer to handle the tax reporting and payment, but in some cases the third party to whom the equipment finance company conveys a beneficial ownership interest of a sub-trust in connection with the syndication of a specific schedule (which we will refer to as the "Investor" or as the "Holder of the sub-trust") prefers that it handle that responsibility itself. As always, it is important to specifically confirm in the lease documents whether the lessee has the obligation or the right to report and pay with respect to taxes, in order to avoid the situation where multiple parties are performing those obligations.

The Servicer would make all payments to the vendor of the Equipment on behalf of the Trust; and would do all billing and collecting (to the extent required) and would perform all administrative responsibility with respect to the Equipment and related Leases. Billing and collecting of rents and sales/use/rental/personal property tax obligations, together with highway and other over-the-road use taxes imposed on the legal title owner of the Motor Vehicles, would be

handled by the Servicer on behalf of the Trust. The equipment finance company would have the right to remove and replace the Servicer under the Servicing Agreement with respect to the general trust assets and the main Trust. The Holder of a specific sub-trust would have the right to remove and replace the Servicer under the Servicing Agreement solely with respect to the sub-trust then held by that Holder.

Role of the Custodian. We also generally provide for a Custodian (which may be the same financial institution acting as trustee or a separate entity in the business of providing custodial services) to maintain possession of the original certificates of title with respect to all Motor Vehicles, together with the chattel paper original Leases (all of which would be held by the Custodian as part of the Equipment File). If the Custodian is not the trustee itself, we suggest that the entity selected to serve as the Custodian be a financial institution since the Custodian should owe a fiduciary obligation to the Investor. Also, if the Investor leverages its investment by obtaining a loan from a third party lender which is secured by the beneficial ownership interest in the sub-trust, it is important to that lender that the Custodian having possession of those important documents have a fiduciary obligation through the Investor to the lender. We have found that lenders take comfort from the fact that the chattel original documents and the original certificates of title are held by an independent third party subject to specific restrictions on release of documents from possession or custody, and prohibitions against taking certain actions, as set forth in the Trust Agreement and/or Custodial Agreement. The Custodian is required to acknowledge receipt of the specific documents comprising the Equipment File, typically including the chattel originals of the lease documents, the original certificates of title and any insurance certificates. The Custodian is prohibited from releasing any or all of the Equipment File except upon receipt of specific written instruction by the appropriate party (that is, the Holder and/or the lender, where applicable). The Investor enjoys the rights and protections of the “Holder” under the Trust Agreement and the Custodial Agreement, and the lender enjoys those rights and protections through the Investor.

## MECHANICS OF USING THE TRUST

The first step is the acquisition of the Equipment and the beneficial ownership interest in the Trust. To permit the Trust to acquire assets, the equipment finance company will fund the Trust in exchange for the beneficial ownership interest in the general trust assets of the Trust. Fundings will be made to the extent of the acquisition cost of the Equipment to be acquired directly by the Trust (including the purchase price and all Federal, state and local taxes which are payable (or which the parties elect to pay) up front). We suggest that the Servicer establish a bank account to be maintained by it on behalf of the Trust and that the equipment finance company deposit the required amount into that account to be applied to pay the acquisition cost and taxes (if applicable) directly to the vendors and/or taxing authorities on behalf of the Trust. By having the flow of funds through the special account maintained on behalf of the Trust, there is a paper trail established substantiating the direct acquisition of the Equipment by the Trust.

Since the Trust is the purchaser of the equipment, the vendor transfers title to the Trust by delivering the bill of sale, invoice and (to the extent that the equipment is comprised of certificate of

title motor vehicles) the MSO. Since the Trust would be both owner and lessor of the Equipment, the Trust may issue a resale exemption certificate (if that exemption is available under applicable state law) upon its acquisition of the equipment. The equipment is brought under the lease when the lessee and the Trust execute the lease agreement or applicable equipment schedule, accepting the equipment under the lease.

General Trust Assets. When Equipment is acquired by the Trust, it will be held, initially, as general trust assets. The equipment finance company will be the owner of the beneficial interest in the general trust assets. The Equipment and related Leases may continue to be held as general trust assets indefinitely, unless and until they are allocated to a sub-trust.

Creation and Allocation to Sub-trusts. From time to time, the equipment finance company will direct the trustee to create one or more sub-trusts and allocate certain Equipment and the related Leases from the general trust assets to those sub-trusts. This allocation is done when the equipment finance company issues an Allocation Notice to the trustee, and the trustee then creates a sub-trust on the books and records of the Trust and allocates the specified assets to that sub-trust. The Trust reflects the allocation of Equipment and related Leases on the books and records maintained by the Trustee. The Delaware statute and the specific provisions of the Trust Agreement require the Trust to maintain separate books and records with respect to each sub-trust.

The Holder of the beneficial ownership interest in the sub-trust may be the equipment finance company or, if the equipment finance company wishes to arrange for the conveyance to an Investor of the Equipment and related Leases held in that sub-trust, then the Investor will be designated as the holder of that sub-trust. At the time of the initial funding of the sub-trust created for the applicable Investor, the beneficial ownership interest in that sub-trust will be conveyed by the equipment finance company to the applicable Investor. Since the Trust is the lessor under the Leases and the right, title, interest and obligations of the Trust, as lessor, under the Leases will be part of the Trust Estate, the rights under the related Leases will be allocated to the sub-trust together with the applicable Equipment. Upon creation of a new sub-trust, the Trust issues a Portfolio Interest Certificate to the Holder of the sub-trust. If the Investor leverages its investment and obtains a loan secured by its beneficial ownership interest in the sub-trust, the lender's lien on the sub-trust is specifically confirmed by a statement to that effect contained in the Portfolio Interest Certificate.

When the beneficial ownership interest in a sub-trust is conveyed, that conveyance will include the beneficial ownership interest not only of the Equipment but also of the related Leases. Legal title to the Equipment remains in the name of the Trust and there is no transfer of legal title to the Investor. The asset transferred to the Investor is the beneficial ownership interest in the specific sub-trust. Since the conveyance is only with respect to the beneficial ownership interest in certain trust assets, and not the legal title ownership of the assets themselves, this structure should avoid the imposition of any sales or excise tax which would otherwise be incurred in connection with the conveyance of title to tangible personal property, since the conveyance is with respect to intangible property only (that is, the beneficial ownership interest in certain sub-trusts).

## Encumbering the Beneficial Ownership Interest in a Sub-Trust.

Warehouse Line of Credit. It is possible to use the beneficial ownership interest in a sub-trust as collateral for a loan. This could be a loan made either to the equipment finance company (perhaps under a warehouse line of credit or a permanent loan), or to an Investor after the conveyance to it of the beneficial ownership interest in a sub-trust. If the equipment finance company uses a warehouse line of credit with respect to transactions to be placed in the titling trust program, a separate sub-trust will be created for use with respect to each Warehouse Lender making an advance under a warehouse line of credit for the equipment finance company. The equipment finance company will direct the trustee to allocate the Equipment and related Leases being financed under the warehouse line of credit from the general trust assets to the sub-trust created with respect to the applicable Warehouse Lender.

The equipment finance company will be the owner/holder of the beneficial interest in the sub-trust and will grant a security interest to the Warehouse Lender with respect to its beneficial ownership interest in the applicable sub-trust, which security interest will be perfected by the filing of a UCC financing statement. It is not necessary for the lien of the Warehouse Lender to be noted on the certificate of title with respect to a motor vehicle. The lien of the Warehouse Lender attaches to the beneficial ownership interest in the sub-trust, which permits the Warehouse Lender to foreclose on that beneficial ownership interest and step into the shoes of the holder of the sub-trust, controlling all of the assets contained in the sub-trust (including the Equipment and the related Leases).

As additional Equipment and related Leases are allocated to that particular sub-trust, the equipment finance company's beneficial ownership interest in that Equipment and related Leases automatically is subjected to the existing security interest in favor of the applicable Warehouse Lender. No UCC financing statement amendments are required to be filed. Similarly, as the warehouse line of credit is paid off with respect to specific lease transactions, the applicable Equipment and related Leases are reallocated out of that sub-trust and the equipment finance company's beneficial ownership interest in that Equipment and related Leases no longer is subject to the security interest held by that Warehouse Lender. No UCC statements of partial release or partial termination are required to be filed.

For the protection of the Warehouse Lender, the Trust Agreement will require the equipment finance company to allocate Equipment and related Leases to the sub-trust created with respect to the applicable Warehouse Lender; and will restrict the ability of the equipment finance company to instruct the trustee to reallocate Equipment and related Leases from the sub-trust created for the Warehouse Lender without the confirmation of that Warehouse Lender. When the warehouse loan is paid with respect to certain Equipment and related Leases, the Warehouse Lender will confirm (a) payment of the warehouse loan to that extent, and (b) authorization for the trustee to reallocate that Equipment and related Leases.

Permanent Financing. If the equipment finance company wishes to arrange for permanent financing with respect to certain Equipment and related Leases, a separate sub-trust will be created for use with respect to each Permanent Lender making a loan to the equipment finance company. As was the case with respect to a warehouse line of credit structure, with respect to permanent financing again the equipment finance company will direct the trustee to allocate the Equipment and related Leases being financed under the permanent loan from the general trust assets to the sub-trust created with respect to the applicable Permanent Lender. The equipment finance company will be the owner/holder of the beneficial interest in the sub-trust and will grant a security interest to the Permanent Lender with respect to its beneficial ownership interest in the applicable sub-trust, which security interest will be perfected by the filing of a UCC financing statement. It is not necessary for the lien of the Permanent Lender to be noted on the certificate of title with respect to a motor vehicle. The lien of the Permanent Lender attaches to the beneficial ownership interest in the sub-trust, which permits the Permanent Lender to foreclose on that beneficial ownership interest and step into the shoes of the holder of the sub-trust, controlling all of the assets contained in the sub-trust (including the Equipment and the related Leases).

As additional Equipment and related Leases are allocated to that particular sub-trust, the equipment finance company's beneficial ownership interest in that Equipment and related Leases automatically is subjected to the existing security interest in favor of the applicable Permanent Lender. No UCC financing statement amendments are required to be filed. Similarly, as Equipment and related Leases are reallocated out of that sub-trust, the equipment finance company's beneficial ownership interest in that Equipment and related Leases no longer is subject to the security interest held by that Permanent Lender. No UCC statements of partial release or partial termination are required to be filed.

For the protection of the Permanent Lender, the Trust Agreement will restrict the ability of the equipment finance company to instruct the trustee to reallocate Equipment and related Leases from the sub-trust created for the Permanent Lender without the confirmation of that Permanent Lender. When the permanent loan is paid with respect to certain Equipment and related Leases, the Permanent Lender will confirm (a) payment of the permanent loan to that extent, and (b) authorize the trustee to reallocate that Equipment and related Leases. The beneficial ownership interest in the sub-trust created with respect to the Permanent Lender shall be retained by the equipment finance company (or may, with the consent of the Permanent Lender, be conveyed to an Investor subject to the lien of the Permanent Lender). The Trust Agreement will require the equipment finance company to allocate Equipment and related Leases to the sub-trust created with respect to the applicable Permanent Lender; and will restrict the ability of the equipment finance company to instruct the trustee to reallocate Equipment and related Leases from the sub-trust created for the Permanent Lender without the confirmation of that Permanent Lender. When the permanent loan is paid with respect to certain Equipment and related Leases, the Permanent Lender will confirm (a) payment of the permanent loan to that extent, and (b) authorization for the trustee to reallocate that Equipment and related Leases.

Syndication. If the equipment finance company wishes to syndicate its interest with respect

to certain Equipment and related Leases, a separate sub-trust will be created for use with respect to each Investor receiving an assignment of the equipment finance company's beneficial ownership interest in certain Equipment and related Leases. The equipment finance company will direct the trustee to allocate the Equipment and related Leases being syndicated from the general trust assets to the sub-trust created with respect to the applicable Investor. The Investor will be the owner/holder of the beneficial interest in the sub-trust. If the Equipment and related Leases to be syndicated to an Investor were financed either through a warehouse loan or a permanent loan, when the warehouse loan or permanent loan is paid with respect to that Equipment and related Leases, the equipment finance company will direct the trustee to reallocate that Equipment and related Leases from the sub-trust created for the Warehouse Lender or Permanent Lender (as applicable), to a sub-trust created with respect to the applicable Investor. The Portfolio Interest Certificate issued by the Trust with respect to the sub-trust will indicate that the Investor is the owner/holder of the beneficial interest in the sub-trust evidenced by the Portfolio Interest Certificate.

After the transfer of beneficial ownership interest has occurred, the Investor is entitled to the tax benefits accruing with respect to all Equipment allocated to its sub-trust and all rent and other payments made under the related Leases.

The Investor will have the right to remove and replace the Servicer under the Servicing Agreement solely with respect to the sub-trust then held by that Investor. The Investor may also elect to withdraw the assets from the titling trust program. Under the terms of the Trust Agreement, the Investor has the right to instruct the Trust to distribute the Equipment and related Leases to the Investor or its nominee, free of the Trust, and to cause any certificate of title motor vehicles to be retitled in the name of the Investor or its nominee (at the expense of the Investor).

#### Special Provisions to be Addressed in the Assignment Agreement.

As part of the syndication process, it is important to remember that the assignment agreement entered into between the equipment finance company and the Investor must be tailored to reflect the involvement of the titling trust program and should include the following special provisions:

- (a) representations with respect to the Trust, including: the creation and continued existence in good standing of the Trust; and the creation of the sub-trust and the allocation to that sub-trust of the Equipment and related Leases;
- (b) conditions precedent including: issuance of the Allocation Notice; and issuance of the Portfolio Interest Certificate and delivery to the Investor; and
- (c) confirmation that the asset being assigned is the beneficial ownership interest in the sub-trust, and not the actual underlying Equipment and related Leases.

In addition, the standard securities law disclaimer and confirmation provisions should be included.

## SECURITIES LAWS COMPLIANCE

That is important because it is unclear whether the conveyance of the beneficial ownership interest in a sub-trust would be construed as the sale of a security for purposes of the Securities Act of 1933, as amended, and applicable state securities laws. The analysis should be the same as that which is applicable with respect to the syndication of a lease financing by the assignment of all or

an interest in a master lease agreement or an equipment schedule or the transfer of a participation interest.

Accordingly, it would be appropriate for the equipment finance company to include in the conveyance instruments appropriate statements, disclaimers and representations by the parties confirming that:

(a) the conveyance of the beneficial interest in the sub-trust may involve the sale of a security and may be subject to restrictions on transferability and resale, except as permitted under applicable Federal and state securities laws;

(b) the beneficial interest in the sub-trust is being offered and sold without registration under Federal and state securities laws, in reliance on an exemption from the registration requirements of those laws; and

(c) the recipient: (1) is acquiring the beneficial interest in the sub-trust solely for its own account, for investment and not with a view to resale, (2) has such knowledge and experience in business and financial matters as is necessary to evaluate the merits and risks of an investment in the beneficial interest, (3) has had access to all financial and other information that it deems necessary to evaluate the merits and risks of an investment in the beneficial interest, and (4) is experienced in making investments in transactions similar to the beneficial interest and is financially able to undertake the risks involved in such an investment.

## SUMMARY BENEFITS OF THE TITLING TRUST PROGRAM

Minimize Administrative Burden and Expense. The benefits of a titling trust program are as follows: . First, the purpose of the use of the titling trust is to avoid the significant administrative burden and expense typically associated with a syndication of the financing of certificate of title motor vehicles. By using the titling trust structure, the Trust is designated as the registered owner on the certificate of title. The initial beneficial owner of the trust assets is the equipment finance company. The equipment finance company may transfer the beneficial ownership interest of the individual sub-trusts without having to re-title the Motor Vehicles, since the conveyance is only with respect to the beneficial ownership interest in certain trust assets, and not the legal title ownership of the assets themselves. This should avoid the imposition of any sales or excise tax which would otherwise be incurred in connection with the conveyance of title to tangible personal property, since the conveyance is with respect to intangible property only; i.e., the beneficial ownership interest in certain sub-trusts.

Dealing with Investors. Second, the equipment finance company would continue to deal with its Investors as it has in the past, using the same sale/assignment documents with only slight modification to reflect the involvement of the titling trust program. Each Investor will have the right to terminate its sub-trust and cause the Equipment and related Leases comprising a portion of the assets of its sub-trust to be transferred and/or re-titled, at its own expense.



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Fiduciary Duty of Trustee. Third, the trustee and Custodian typically are independent financial institutions which owe a fiduciary obligation to the beneficiaries of the master trust and the various sub-trusts. The rights, and limitations on the ability of the trustee and Custodian to take actions, with respect to the trust assets will be clearly delineated in the Trust Agreement.