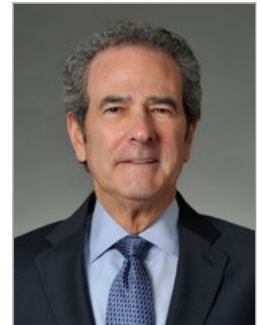


The Whys And Hows Of Motor Vehicle Titling Trusts: Part 1

By **Alan Mogol**

Law360, New York (August 24, 2017, 12:06 PM EDT) -- 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 requiring the filing of paperwork and the payment of an 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.



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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.

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.

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.

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.

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.

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.

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 of 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).

The second part of this article will examine how the beneficial ownership interest in a sub-trust may be used for warehouse financing, permanent financing and syndication, and the importance of compliance with securities laws in syndication arrangements.

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