

LOS ANGELES DAILY JOURNAL

Monday, February 2, 1998

Seeking Perfection Federal Grace Period Pre-empts State Law

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Under Bankruptcy Code Section 547(b), trustees - or in Chapter 11 cases where a trustee has not been appointed, debtors in possession - may bring a preference action to avoid pre-bankruptcy transfers of a debtor's property interest.

According to Section 547(b), a preference action may be brought if the transfer is to or for the benefit of a creditor; for or on account of an antecedent debt owed by the debtor; made while the debtor was insolvent; occurred within 90 days of the date of the filing of the bankruptcy petition (or within one year if the creditor was an insider); and enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor if the transfer had not been made.

There are eight statutory exceptions to preference actions. 11 U.S.C. Section 547(c). One of the exceptions prevents trustees from avoiding purchase-money security interests (also called enabling loans) that meet a number of conditions. 11 U.S.C. Section 547(c) (3). Under Section 547(c)(3)(B), one of these conditions is that the security interest must be perfected on or before 20 days after the debtor receives possession of the property.

Federal circuit courts have split on their interpretations of this last element of the enabling loan exception. The 9th and 5th U.S. Circuit Court of Appeals have held that the 20-day grace period for perfection under Section 547(c)(3)(B) pre-empts any longer grace period provided by state law. *In re Walker*, 77 F.3d 322(9th Cir.1996); *In re Hamilton*, 892 F.2d 1230 (5th Cir. 1990); *In re Locklin*, 101 F.3d 435 (5th Cir. 1996).

The 10th and 11th Circuits have disagreed, holding that the Bankruptcy Code adopts state law to determine the date that a transfer is perfected under Section 547(c)(3)(B). *In re Hesser*, 984 F.2d 345 (10th Cir. 1993); *In re Busenlehner*, 918 F.2d 928 (11th Cir. 1990).

The U.S. Supreme Court granted certiorari to resolve the conflict among the circuits and to answer the question of whether a creditor may invoke the enabling loan exception when "it performs the acts necessary to perfect its security interest more than 20 days after the debtor received the property, but within a relation-back or grace period provided by the otherwise applicable state law." *Fidelity Financial Services v. Fink, Trustee*, 98 Daily Journal D.A.R. 392(Jan. 14, 1998).

In *Fidelity*, the debtor used a loan from Fidelity to purchase a 1994 Ford and gave Fidelity a promissory note secured by the new car for the purchase price. On that same day, the debtor

drove away in her Ford. Twenty-one days later, Fidelity mailed the application necessary to perfect its security interest under Missouri law to the Missouri department of Revenue.

Missouri law provides that a "lien or encumbrance on a motor vehicle...is perfected by the delivery [of specified documents] to the director or revenue," but the date of the lien's perfection is "as of the time of its creation if the delivery of the aforesaid to the director of revenue is completed within 30 days thereafter, otherwise as of the time of the delivery." Missouri Revised Statutes section 301.600(2).

Two months after purchasing her Ford, the debtor filed a bankruptcy petition. Thereafter, the trustee appointed in the debtor's bankruptcy case sought to set aside Fidelity's security interest in the car. The trustee contended that Fidelity's lien was a voidable preference and that the enabling loan exception did not apply because fidelity failed to perfect its interest within 20 days after the debtor received the car.

Fidelity countered by citing the provision in Missouri law providing that a lien on a motor vehicle is "perfected" from the date of its creation (in this case, within the 20-day period), if the creditor files the necessary documents within 30 days after the debtor takes possession.

Assuming that all of the elements of a preference under Section 547(b) were satisfied, the trustee could still not avoid Fidelity's lien on the debtor's Ford if it came within the enabling loan exception of Section 547(c)(3). The only issue before the Supreme Court was whether Fidelity's lien had been perfected on or before 20 days after the debtor received possession of the Ford in accordance with the enabling loan exception requirement of Section 547(c)(3)(B).

The court explained that perfection turns on the definition provided by Section 547(e)(1)(B) that "a transfer of...property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."

In general, as noted by the 9th Circuit in *Walker*, "the property interests on which bankruptcy acts are regularly the rights recognized by state law." However, according to the *Walker* court, what constitutes a transfer and when it is perfected is a matter of federal law.

Examining the text of the Bankruptcy Code, the court concluded that Congress understood perfection in two different senses: "Congress sometimes used the word 'perfection' to mean the legal conclusion that for such purposes as calculating priorities perfection of a lien should be treated as if it had occurred on a particular date, and sometimes used it to refer to the act necessary to support that conclusion."

The court found that the language of Section 547(e)(1)(B) dictated that the Missouri relation-back provision could not save Fidelity's lien. "Section 547(e)(1)(b) says that a transfer is perfected 'when' a contract creditor 'cannot acquire' a superior lien. A creditor 'can' acquire such a lien at any time until the secured party performs the acts sufficient to protect its interests . . . Not until the secured party actually performs the final act that will perfect its interest can other creditors be foreclosed conclusively from obtaining a superior lien." Thus, a lien cannot be perfected at the moment state law may retroactively deem the perfection effective.

The court identified several considerations supporting its conclusion. First, the court pointed to Section 546, which places certain limits on avoidance powers, including the provision of Section 546(b)(1)(A) that the "rights and powers of a trustee under sections 544,545,and 549 of this title are subject to any generally applicable law...that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection."

Because Congress omitted Section 547 from this provision, the court found the negative implication to be that Congress intended a trustee's power to avoid pre-petition preferences to prevail over state relation-back provisions or grace periods.

Second, the court noted that the bankruptcy Code has been amended in 1994 to extend the perfection period under Section 547(c)(3)(B) from 10 to 20 days. At the time of the 1994 amendment, most states had adopted some version of Article 9-301(2) of the Uniform Commercial Code, which provides for a 10-day relation-back period for perfection of purchase-money security interests. However, 42 states had adopted modifications extending the grace period to 20 days or more after the debtor's first possession of the collateral. See California Commercial Code Section 9-301(2).

The court found that if Congress had agreed with Fidelity's view of the way Section 547(c)(3) acts together with state law, the 1994 amendment would have extended the period in only the few states that laced the 20-day grace period and would not have precluded a state from choosing a longer period.

Accordingly, the court stated, "the net effect of the 1994 amendment would thus have been merely to benefit a class of creditors in only eight States, Guam and the District of Columbia, jurisdictions which could have looked out for their own creditors if they had chosen to do so. It is not easy to imagine that Congress meant to accomplish nothing more, and nothing uniform, by its effort."

Finally, reviewing the former version of the preference provisions in Section 60 of the previous Bankruptcy Act, the court recognized that, while that version "looked to state law rules to determine the effective date of transfer, [it] did not allow those rules to extend the creditor's opportunity to act beyond the uniform outer time limit [21 days] that it provided."

Consequently, the court concluded that Congress intended Section 547(c)(3)(B) to establish a uniform federal perfection period - immune to alteration by state-law grace periods.

Accordingly, a creditor can find protection under the enabling loan exception of Section 547(c)(3) only by acting to perfect its security interest within 20 days after the debtor receives possession of the collateral.