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# From the Bankruptcy Courts

*Benjamin Weintraub\* and Alan N. Resnick\*\**

## **PURCHASE MONEY SECURITY INTERESTS AS PREFERENCES—THE DANGER OF RELYING ON STATE VARIATIONS OF UCC PERFECTION GRACE PERIODS**

Section 1-102(2)(c) of the Uniform Commercial Code provides that one of the purposes of that statute is to "make uniform the law among the various jurisdictions." Nonetheless, lawyers who have had experience with the UCC know that blind reliance on the uniformity of this complex body of commercial law may be dangerous. State variations are common and must be carefully considered when applying this statute.

A pitfall for the practitioner may occur when a nonuniform variation is adopted that disturbs the carefully planned harmony be-

tween the Bankruptcy Code and the Uniform Commercial Code. In formulating the Bankruptcy Code as part of the Bankruptcy Reform Act of 1978, Congress tailored certain provisions of the federal statute to be consistent with Article 9 of the UCC. An illustration of this harmony is found in section 547 of the Bankruptcy Code dealing with voidable preferences.

### **Voidable Preferences and the Bankruptcy Code**

Article 9 of the Uniform Commercial Code contains several provisions designed to encourage purchase money lending by giving the purchase money secured party the ability to defeat other prior-in-time interests in certain situations. For example, section 9-301(2) provides:

If the secured party files with respect to a purchase money security interest before or within ten days after the debtor receives possession of the collateral, he takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attaches and the time of filing.

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Suppose that on May 1 a seller delivers goods to a buyer on credit and the parties sign a security agreement giving the seller a purchase money security interest. On May 4, another creditor obtains a judicial lien on the goods, and on May 8 the seller perfects the security interest by filing. Under section 9-301(2), the seller would have priority over the judicial lien creditor because the purchase money security interest was perfected within the ten-day "grace period." In contrast, if the security interest is not purchase money, the judicial lien creditor would have priority because of the general "first-in-time" provision in section 9-301(1)(b).

A similar ten-day grace period for purchase money secured parties is found in section 9-312(4) and is designed to enable a debtor to offer a purchase money lender a first priority lien on new equipment despite the existence of a prior-in-time security interest in after-acquired property. Section 9-312(4) provides: "A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter."

Congress had these UCC ten-day grace periods in mind when it adopted section 547 of the Bank-

ruptcy Code. One element that must be satisfied to prove a preference under section 547 is that the transfer of the debtor's interest in property was "for or on account of an antecedent debt."<sup>1</sup> The way to determine whether a transfer is for an antecedent debt is to determine the time when the debt was incurred and the time when the transfer took place. If a debt was incurred on March 1 and a transfer to the creditor occurred on March 12, the antecedent debt element has been satisfied. But if the debt was incurred and the transfer took place at the same time, the transfer could not be avoided as a preference.

The former Bankruptcy Act provided, in essence, that the transfer of security interest takes place for preference purposes when it is perfected, unless it is perfected within twenty-one days after the time that it became enforceable between the debtor and the secured party.<sup>2</sup> If perfected within the twenty-one-day grace period, the time of the transfer related back to the date when the security interest attached. For example, if on November 1 the parties signed a security agreement, the debtor had an interest in the collateral, and the credit was extended, and on November 18 the security interest was perfected by filing, the

<sup>1</sup> 11 U.S.C. § 547(b)(2).

<sup>2</sup> See former Bankruptcy Act § 60a(7).

time of the transfer of the security interest would have related back to November 1 under the former Act. Since the debt was incurred and the transfer took place on November 1, there would be no transfer for an antecedent debt and the security interest would survive any preference attack.

In 1978, however, Congress replaced the old twenty-one day period with a ten-day relation-back period in section 547(e)(2) of the Bankruptcy Code. This change conformed the Bankruptcy Code to the various ten-day grace periods in Article 9 of the UCC. If a debt is incurred and a security interest attaches on January 1 but perfection does not occur until January 14, a trustee in bankruptcy may be able to avoid the security interest as a preference if the debtor files a bankruptcy petition within ninety days after January 14 and the other elements of a preference are present. Similarly, section 547(c)(3) created an exception to the preference provisions for purchase money security interests that are perfected within ten days after the debtor receives possession of the goods (regardless of when the security interest first becomes enforceable between the parties). Section 547(c)(3) was designed to give the purchase money secured party the same protection against a trustee in bankruptcy as it enjoys against a judicial lien creditor under section 9-301(2) of the UCC.

### Deviating From Uniformity

Despite this deliberate conformity between the UCC and the Bankruptcy Code, many states deviate from the official version of the Uniform Commercial Code to enlarge the grace periods for purchase money security interests. For example, UCC sections 9-301(2) and 9-312(4) have been amended in the majority of states to increase the ten-day periods to twenty days.<sup>3</sup> These variations give purchase money secured parties more time in which to perfect in order to defeat intervening judicial lien creditors and other secured creditors with interests in the same collateral.

A danger in amending Article 9 in this fashion is that it may lull purchase money secured creditors into a false sense of security (no pun intended) by giving them the impression that their positions are safe if they perfect within twenty days. However, the purchase money secured creditor that relies on the twenty-day period in which to perfect may be surprised to find a trustee in bankruptcy avoiding the security interest as a preference in a subsequent bankruptcy case.

A recent case that illustrates this problem for purchase money

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<sup>3</sup> See 3 U.L.A. (Master Edition & 1989 Supp.) for a list of states that have adopted variations from the Official Text of the Uniform Commercial Code.

secured creditors is *In re Holder*<sup>4</sup> in which a chapter 13 trustee sought to avoid a purchase money security interest on a motor vehicle as a voidable preference. On July 24, 1987, Wachovia Bank & Trust Company, N.A., and the debtor executed a note and security agreement giving the bank a purchase money security interest in a 1987 Dodge truck. Pursuant to the North Carolina state law applicable to perfection of security interests in motor vehicles, the certificate of title to the truck revealed that the lien was perfected on August 12, 1987. The debtor filed a chapter 13 petition on November 2 of the same year, and the trustee argued that the security interest was a transfer for an antecedent debt and therefore a voidable preference because it was not perfected within the ten-day relation-back period under section 547(e)(2) of the Bankruptcy Code. The bank argued, however, that the security interest may not be avoided as a preference because it was perfected within the twenty-day grace period provided by the nonuniform version of section 9-301(2) of North Carolina's Uniform Commercial Code.

The bankruptcy court stated the threshold issue as

[W]hether, despite the federally mandated 10-day grace period

found in 11 U.S.C. 547(e)(2), the 20-day grace period allowed under North Carolina Gen. Stat. 25-9-302(2) for the perfection of purchase money security interests would cause the lien placed on the vehicle August 12, 1987, to relate back to the purchase date of July 24, 1987.<sup>5</sup>

The court then focused on each of the elements of a preference set forth in section 547 and commented that this section must be "strictly followed" even though it is "sometimes harsh in its application."<sup>6</sup>

In determining the time of the transfer of a security interest under section 547(e), the court noted that state law determines the time of perfection. Under North Carolina law, as in many other states, perfection of security interests in motor vehicles is governed by a statute that is separate from the Uniform Commercial Code. Section 25-9-902(3)(b) of North Carolina's General Statutes provides that a certificate of title statute applies regarding the time of perfection. The court also concluded that the twenty-day grace period in section 9-301(2) of the UCC does not apply at all with respect to motor vehicles. Accordingly, the bank's reliance on section 9-301(2) was erroneous.

Nonetheless, the court in dictum analyzed and rejected the

<sup>4</sup> 94 Bankr. 395 (Bankr. M.D.N.C. 1988).

<sup>5</sup> *Id.* at 396-397.

<sup>6</sup> *Id.* at 397.

argument that perfection of a purchase money security interest within the twenty-day grace period under section 9-301(2) saves it from attack as a voidable preference under the Bankruptcy Code. The majority of courts that have faced this issue have held as follows:

[S]tate law is appropriate for determining the date of perfection, however, the date of transfer is governed by the provisions of section 547 [of the Bankruptcy Code]. The state grace period is not a relation back provision which controls the date of transfer, but rather, the date of transfer is exclusively controlled by 11 U.S.C. section 547(e)(2).<sup>7</sup>

The court further explained the danger of a purchase money secured party relying on the state twenty-day grace period instead of perfecting within ten days:

[E]ven assuming *arguendo*, that North Carolina provided a 20-day grace period for filing purchase money security interests in motor vehicles, this grace period would not govern the date of transfer, but merely the date of perfection under state law, this Court would still be forced to apply section 547(e)(2) to determine the date of transfer. A creditor can perfect its interest in collateral creating a lien thereon by filing at any time, and that lien will be good as to other subsequent lienholders in a state court proceeding. However, if that lien

is not perfected within the 10-day window allowed by section 547(e)(2) and that creditor finds itself entangled in a bankruptcy proceeding in a federal Bankruptcy Court, that lien is avoidable by the Trustee in bankruptcy as a preference.<sup>8</sup>

Since the security interest in the debtor's truck was perfected more than ten days after it attached, the court held that it was a transfer for an antecedent debt under section 547(e)(2) and, therefore, it met all of the elements of a preference under section 547(b).

### Exceptions Not Applicable

Section 547(c)(3) of the Bankruptcy Code contains an exception for security interests given in connection with "enabling loans." In essence, the exception protects purchase money security interests that are transfers for antecedent debts because they are perfected more than ten days after attachment but are perfected within ten days after the delivery of the collateral to the debtor. For example, suppose that a seller and buyer sign a purchase money security agreement and the goods are shipped to the buyer on May 1, the goods are delivered to the buyer on May 8, and the security interest is perfected by filing on May 16. Since perfection took place more than ten days after

<sup>7</sup> *Id.* at 398.

<sup>8</sup> *Id.*

attachment of the security interest, the security interest is a transfer on account of an antecedent debt under section 547(e)(2). However, section 547(c)(3) saves the transfer from a preference attack because it was perfected within ten days after the debtor received possession of the goods. This exception was designed to conform to section 9-301(2), which measures the ten-day grace period from the delivery of goods to the debtor, not the time of attachment of the security interest.

In *Holder*, the court held that section 547(c)(3) is not applicable because the security interest was not perfected "within ten days after the security interest attached."<sup>9</sup> Although the court erroneously measured the ten-day grace period under the "enabling loan" exception from the time of attachment instead of the time of delivery of the collateral,<sup>10</sup> the holding would have been the same under the correct analysis if the truck was delivered more than ten days prior to perfection. The opinion does not indicate the date on which the debtor received possession of the truck.

The court also rejected the bank's argument that it was pro-

tected under the "contemporaneous exchange" exception under section 547(c)(1). That provision states:

The trustee may not avoid under this section a transfer—(1) to the extent that such transfer was— (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange.

The court followed the majority view that "section 547(c)(3) is the exclusive exception available to protect purchase money security interests from avoidance."<sup>11</sup> The legislative intent behind section 547(c)(1), according to the court, was "to address the problems involving bank checking account transactions, where the parties did not intend such contemporaneous transfers to be credit transactions though they literally might be considered such."<sup>12</sup> Also, if purchase money security interests perfected outside the ten-day grace period provided in section 547(c)(3) may be protected as contemporaneous exchanges under section 547(c)(1), section 547(c)(3) would be rendered "meaningless and devoid of any useful application."<sup>13</sup> The court applied the doctrine of

<sup>9</sup> *Id.* at 399.

<sup>10</sup> Apparently, the court relied on the pre-1984 version of § 547(c)(3). In 1984, the section was amended to measure the ten-day grace period from the date of the debtor's possession of the goods.

<sup>11</sup> 94 Bankr. at 400.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

statutory construction that "[a] statute should not be interpreted by a court so as to render one part of the statute inoperative, superfluous, or insignificant."<sup>14</sup> Accordingly, the court held that the security interest in the truck could not be saved by the "contemporaneous exchange" exception under section 547(c)(1).

### Conclusion

The *Holder* decision should serve as a warning to secured creditors and counsel who may take comfort in state legislation that increases the grace period for perfection of purchase money security interests contained in sections 9-301(2) or 9-312(4) of the UCC.<sup>15</sup> Although Congress care-

fully conformed certain provisions of the Bankruptcy Code to the time provisions of the Uniform Commercial Code, state variations of the UCC may mislead practitioners who fail to recognize that reliance on such variations may create pitfalls if the debtor finds it necessary to seek financial protection under the Bankruptcy Code. Despite the enlargement of state grace periods, secured creditors that want to avoid the danger of losing their liens as voidable preferences should be sure to perfect within the ten-day relation-back period found in section 547(e)(2).

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ated and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding . . .").

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<sup>14</sup> *Id.*

<sup>15</sup> See *Butner v. United States*, 440 U.S. 48, 54 (1979) ("Property interests are cre-