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From the Bankruptcy Courts: A Flexible Standard for Shielding Tardily Perfected Security Interests from Preference Attack

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Equality of treatment of similarly situated creditors is a basic policy underlying the Bankruptcy Code. Consistent with that policy, the Code gives the trustee or debtor in possession the power to avoid certain preferential transfers made to creditors shortly before a debtor's bankruptcy. In particular, if within the statutory preference period before the commencement of a bankruptcy case, the debtor while insolvent transferred an interest in property to a creditor on account of an antecedent debt, the Code permits the avoidance of the transfer if it enables the creditor to receive more than it would receive in a liquidation case had the transfer not been made.[1] The creditor is thus deprived of the unfair advantage it would have obtained from the prebankruptcy transfer.

In order to know whether a transfer constitutes an avoidable preference, it is necessary to determine the time of the transfer for two reasons. First, only transfers occurring within 90 days—or within one year if the transfer benefits an insider creditor—before the bankruptcy case commences may be avoided as preferences. Second, the time of the transfer will determine whether it was on account of an *antecedent* debt. Section 547(e) of the Code provides that, for preference purposes, a transfer occurs at the time it first becomes effective between the transferor and the transferee, but only if it is perfected within ten days after that time.[2] If perfection occurs after the ten-day period, the transfer is deemed to occur at the time of perfection.

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[1] *See* 11 U.S.C. § 547. The statutory preference period is 90 days before the commencement of the bankruptcy case, or one year before bankruptcy if the creditor was an insider at the time of the transfer. 11 U.S.C. § 547(b)(4).

[2] 11 U.S.C. § 547(e)(2). In general, a transfer of an interest in real estate, other than fixtures, is "perfected" when a bona fide purchaser of the property could not acquire an interest that is superior to the interest of the transferee. A conveyance of a fee interest in land, or of a real estate mortgage, is perfected when the deed or mortgage is recorded. A transfer of personal property or a fixture is "perfected" when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee. 11 U.S.C. § 547(e)(1).

For example, suppose that a creditor gave the debtor a loan on March 1 and, on that date, the parties executed a security agreement that granted the creditor a security interest in the debtor's equipment. Under Article 9 of the Uniform Commercial Code, the security interest attached and became effective between the debtor and the creditor on March 1. Assume further that a financing statement was filed on March 18 to perfect the security interest. The debtor was insolvent during that time period and, on June 6, the debtor filed a bankruptcy petition. Because the security interest in the equipment was perfected more than ten days after the security interest attached, the transfer of the security interest is deemed to have been made for preference purposes on March 18, which was within 90 days of bankruptcy. In addition, the transfer was on account of an antecedent debt because the debt was incurred on March 1 and the transfer was made for preference purposes on March 18. Therefore, the delayed perfection renders the security interest vulnerable to attack as a voidable preference. On the other hand, if perfection had occurred on March 9, the transfer would be deemed to have been made on March 1 and, accordingly, it would not have occurred within the 90-day preference period and also would not have been a transfer for an *antecedent* debt.

Despite the presence of all the elements of a voidable preference under Section 547(b) of the Code, several exceptions found in Section 547(c) will shield certain prebankruptcy transfers from a preference attack. One exception, often referred to as the enabling loan exception, is designed to lengthen the 10-day grace period when perfecting a purchase money security interest. Under Section 547(c)(3), an otherwise preferential security interest is not avoidable if it is a purchase money security interest that is perfected within 20 days after the debtor receives possession of the collateral.[3] For example, if the security interest in the above hypothetical was given to obtain the funds used to purchase the collateral, and the debtor obtained possession of the collateral on March 15, the security interest would not be subject to preference attack because of the enabling loan exception under Section 547(c)(3).

Contemporaneous Exchange for New Value

Another provision of the Code, Section 547(c)(1), shields from preference attack a transfer that was intended by the parties to be, and was in fact, a substantially contemporaneous exchange for new value given to the debtor.[4] As discussed above, a transfer of a security interest takes place at the time of perfection if it is not perfected within ten days after

[3] *See* 11 U.S.C. § 547(c)(3) for greater detail regarding the requirements for this exception. Before Section § 547(c)(3) was amended in 1994, the applicable period was ten days after the debtor received possession of the collateral.

[4] *See* 11 U.S.C. § 547(c)(1).

the security interest attaches. An issue that courts have had to face is whether a security interest that is perfected more than ten days after its attachment, thereby constituting a transfer on account of an antecedent debt, could be a contemporaneous exchange for new value protected under Section 547(c)(1).

A recent district court decision that illustrates a trend in resolving this question is *In re Stephens,*[5] where a debtor granted a bank a security interest in connection with refinancing an automobile loan. The debtors, a husband and wife, owned a 1991 Ford Bronco that was purchased with the proceeds of a loan from Ford Motor Credit Corp. (FMCC). FMCC held a security interest in the Ford Bronco that was perfected by notation of the lien on the certificate of title in accordance with state law.

In 1997, the debtors sought to refinance the FMCC loan to obtain a lower interest rate. For that purpose, they executed a credit application form and submitted it to Chisolm Trail State Bank ("the Bank") on July 21, 1997. On the same day, the debtors executed and delivered to the Bank a secured promissory note wherein they pledged the vehicle to the Bank, and an "Application for Secured, Duplicate, Reissue Title" form listing the Bank as a lienholder. The debtors also delivered the original certificate of title to the Bank. Also on July 21, the Bank issued a cashier's check payable to FMCC and containing a notation that it was a payoff of the debtors' FMCC account. The cashier's check was immediately mailed to FMCC, which deposited it on July 23 and released its lien on the lienholder's copy of the title and registration application.

Upon receipt of FMCC's copy of the title and registration application, the Bank forwarded it together with the original certificate of title and the applicable fee to the appropriate state agency. The date of the title and registration application was August 4th. The state issued the new title to the vehicle—showing the debtors as owners and the Bank as lienholder—on September 2, 1997.

The debtors filed a petition for relief under Chapter 7 of the Bankruptcy Code on October 24, 1997. The trustee commenced an action seeking to avoid the Bank's security interest in the Ford Bronco as a preference under Section 547(b). The parties stipulated that the debtors and the Bank intended the loan and the granting of the security interest in the vehicle to occur at the same time. They also stipulated that unsecured creditors will be paid less than 100 percent of their claims in the bankruptcy case. Accordingly, unless avoided, the granting of the security interest would enable the Bank to receive more than it would otherwise receive as an unsecured creditor in the Chapter 7 case.

The Trustee's Argument

The trustee contended that the security interest may be avoided as a preference because it was a transfer

[5] 242 B.R. 508 (Bankr. D. Kan. 1999).

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on account of an antecedent debt made within 90 days of bankruptcy while the debtors were insolvent. He reasoned that the security interest became effective between the debtors and the Bank on July 21, but it was not perfected until August 4. Because perfection occurred more than 10 days after the July 21 effective date, under Section 547(e)(2), the date of the transfer for preference purposes was August 4. Of course, the debt was incurred on July 21, thereby rendering the granting of the security interest a transfer on account of an antecedent debt.

The Bank did not dispute the contention that the grant of the security interest was a transfer that met all the elements of an avoidable preference under Section 547(b). The Bank took the position, however, that the security interest was protected from preference attack under Section 547(c)(1) because it was a substantially contemporaneous exchange for new value. The trustee countered that the "substantially contemporaneous exchange" exception does not apply to a security interest perfected more than ten days after attachment—a position that is supported by case law.[6]

The Bank responded that the ten-day provision found in Section 547(e)(2) "does not delineate the boundaries" of a "substantially contemporaneous exchange" under Section 547(c).[7] It argued that the use of the term "substantially contemporaneous," rather than a specific time limit "shows that Congress intended to adopt a flexible standard requiring an analysis of all the facts surrounding the transfer."[8] As the district court noted, the Bank's position also was supported by existing case law.[9] The Bank was successful in persuading the bankruptcy court that the ten-day provision in Section 547(e)(2) does not preclude a finding that the transfer and the loan were substantially contemporaneous.

District Court Affirms

On appeal, the district court acknowledged that both the trustee's view and the Bank's view on the applicability of the substantially contemporaneous exchange exception to a security interest perfected more than 10 days after attachment "can claim some support from the text and structure of §547."[10] The trustee's view is supported by the language of Section 547(e)(2), which determines when a transfer is made "for purposes of this section,"[11] which includes the subsection on substantially contemporaneous exchanges for new value. Moreover, the district

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[6] The district court cited *In re* Arnett, 731 F.2d 358 (6th Cir. 1984), and its progeny as authority supporting the trustee's position that the security interest was not a "substantially contemporaneous" exchange because it was perfected more than ten days after it attached.

[7] 242 B.R. at 510.

[8] *Id.*

[9] The district court cited Pine Top Ins. Co. v. Bank of Am. Nat'l. Sav. Ass'n, 969 F.2d 321 (7th Cir. 1992), and its progeny.

[10] 242 B.R. at 510.

[11] 11 U.S.C. § 547(e)(2).

court cited authority for the position that the time limit in Section 547(c)(3) regarding purchase money security interests precludes application of the substantially contemporaneous exchange exception.[12] For these reasons, the district court found that the trustee's argument "has some logical force."[13] However, the district court also noted that the Bank's view—that a grant of a security interest could qualify as a substantially contemporaneous exchange for a loan notwithstanding the fact that it was not perfected within 10 days after attachment—is "bolstered by Congress' use of a subjective (and somewhat vague) standard in subsection (c)(1) instead of an objective and specific time limit, such as appears frequently in other provisions of the Code."[14]

Flexible Standard Adopted

On balance, the district court concluded that the approach taken by the bankruptcy court—which adopted the Bank's view that the substantially contemporaneous provision in Section 547(c)(1) could apply even if perfection takes place after the crucial 10-day period—is the better approach. The district court referred to the decision of the Eighth Circuit Bankruptcy Appellate Panel in *In re Dorholt,*[15] where the panel noted that Congress' use of the phrase "substantially contemporaneous" indicated that a flexible standard was intended instead of a specific time limit.[16] The district court in *Stephens* noted that "contemporaneous" is defined in *Webster's Dictionary* to mean "existing or occurring during the same time (as during a year, decade, or longer span of time)" or "originating, arising, or being formed or made at the same time; marked by characteristics compatible with such origin."[17] The flexible standard requires the court to examine the length of the delay, as well as the reason for the delay, nature of the transaction, intent of the parties, and the possible risk of fraud.[18]

The district court then addressed possible concerns that saving security interests not perfected within 10 days after attachment from preference attack would inevitably lead to the protection of secret liens.

> "Any concern over the possible creation of secret liens by a creditor 'should ... be allayed by a court's examination and consideration of the reasonableness of a delay in perfection. Where there is a reasonable and plausible explanation for the delay, there should be no concern that a creditor was recording a secret lien in anticipation of bankruptcy."[19]

[12] The court cited *In re* Tressler, 771 F.2d 791 (3rd Cir. 1985).

[13] 242 B.R. at 510.

[14] *Id.*

[15] 239 B.R. 521 (8th Cir. BAP 1999).

[16] 242 B.R. at 511.

[17] 242 B.R. at 511 n.2 (citing *Webster's Third New Int'l. Dictionary (1961)).*

[18] *See In re* Dorholt, Inc., 239 B.R. at 525.

[19] 242 B.R. at 511 (quoting from *In re* Dorholt, 239 B.R. at 525, which cited *In re* Marino, 193 B.R. 907, 915 (9th Cir. BAP 1996, aff'd, 117 F.3d 1425 (9th Cir. 1997)). The district court in *Stephens* also cited *In re* Carson, 119 B.R. 264 (Bankr. E.D. Okla. 1990), where the court held that perfection

Application of the Flexible Standard to the Facts

Applying the substantially contemporaneous exchange exception to the facts, the district court emphasized that the delay between the loan transaction and perfection of the security interest was only 14 days and was caused by reasons that were not within the Bank's control. The Bank promptly sent its check to FMCC to pay off the existing lien, and then forwarded the registration documents noting the Bank's lien to the Department of Motor Vehicles a soon as the Bank received from FMCC the required documentation releasing its lien. The bankruptcy court found that the delay was not unreasonable and that in these particular circumstances the transfer of the security interest was substantially contemporaneous with the loan. The district court, holding that the issue of whether the transfer and the loan were substantially contemporaneous is a question of fact and that the bankruptcy court's findings on that issue were not clearly erroneous, affirmed the judgment in favor of the Bank.

Conclusion

Within the first decade after the enactment of the Bankruptcy Code, most courts faced with the issue held that the substantially contemporaneous exchange exception in Section 547(c)(1) was not applicable where a security interest was perfected more than 10 days after the loan was given and the security interest attached. These transfers were often voided as preferences.[20] More recently, however, there have been a number of decisions similar to that in *In re Stephens* in which courts have taken a more flexible approach, applying Section 547(c)(1) to save otherwise preferential transfers where perfection was delayed for more than ten days.[21] As a Ninth Circuit Bankruptcy Appellate Panel wrote a few years ago:

> "[W]e find that a flexible standard best comports with the policies of § 547, and adopt it with respect to the requirement of §547(c)(1)(B) that a transfer be substantially contemporaneous in fact. Instead of applying the strict ten-day limit enumerated in § 547(e)(2), an inquiry into the facts and circumstances of the particular transaction should be made to determine whether a transfer was substantially contemporaneous in fact."[22]

Despite the trend to a more relaxed standard, secured lenders and their lawyers should not assume that they will be protected by a case by case determination regarding the provisions of Section 547(c)(1) and (e),

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of a security interest in the debtor's vehicle 14 days after the loan and the signing of the security agreement was a substantially contemporaneous exchange for new value under Section 547(c)(1)).

[20] *See, e.g., In re* Arnett, 731 F. 358 (6th Cir. 1984).

[21] *See, e.g., In re* Marino, 193 B.R. 907 (9th Cir. BAP 1996), *aff'd.* 117 F.3d 1425 (9th Cir 1997); Pine Top Ins. Co. v. Bank of Am. Nat'l. Sav. Ass'n., 969 F.2d 321 (7th Cir. 1992).

[22] Marino, 193 B.R. at 915-916.

and should always attempt to perfect security interests as soon as possible. If perfection occurs within ten days after the loan transaction and attachment of the lien, litigation on whether granting the security interest was a substantially contemporaneous exchange for the loan may be avoided entirely in a subsequent bankruptcy case.