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BANKRUPTCY – PREFERENCE AVOIDANCE AND TIMELY PERFECTION OF MOTOR VEHICLE LIENS

THE ISSUE

A borrower finances a motor vehicle purchase and quickly files for bankruptcy. Even if the lender managed to perfect its lien prior to the bankruptcy filing, the bankruptcy trustee may still avoid the lender's lien, take possession of and sell the vehicle.

In short, under 11 U.S.C. § 547, a bankruptcy trustee may avoid any transfer of an interest of the debtor to a creditor made within <u>90 days</u> of a bankruptcy filing, except a transfer that creates a security interest in property to secure payment of the purchase price that is perfected on or before 30 days after the debtor receives possession of such property.

A trustee's exercise of his rights under section 547 is commonly referred to as "preference avoidance." Since the lender, in agreeing to finance the vehicle purchase, would be entitled to receive more from the debtor than it would had the transfer not been made, the trustee is given the power to avoid this result to ensure that all creditors receive their fair share.

Despite numerous states permitting electronic recordation of motor vehicle liens, dealerships continue to jeopardize such liens by failing to timely perfect.

PRACTICAL EFFECT ON CLIENT

<u>Lawsuit</u> - To avoid a preferential transfer, the bankruptcy trustee will commence an adversary proceeding and serve a copy of the complaint (together with a summons) on the lender. The lender must then respond within 30 days of the date of the issuance of the summons or risk the entry of a default and a separate default judgment avoiding the lender's lien on the vehicle.

<u>Attorney</u> - The lender is forced to hire counsel to review the allegations contained within the complaint and determine whether there are any viable defenses.

<u>Dealership</u> – If the bankruptcy trustee is successful, the lender is left with no security interest in the vehicle, leaving it with only an unsecured claim against the bankruptcy estate. The lender is then forced to seek recourse against the dealership that failed to timely perfect the lien, thereby compromising future business relations.

ECONOMIC EFFECT ON CLIENT

<u>Time</u> - The lender must expend time and incur costs in: reviewing the lawsuit, contract and title documents; hiring an attorney; and monitoring the lawsuit. Additional time and expense may be incurred in contacting and seeking indemnification from the dealer.

<u>Loss of Collateral</u> – If a bankruptcy trustee successfully avoids an auto lien, the lender is left with an unsecured claim, which entitles the lender to only a pro rata share of any disbursement made by the trustee (usually a minimal amount, depending on the value of the debtor's assets, including the vehicle, after taking into account the debtor's exemptions and the trustee's administrative fees).

<u>Capital Expenditure</u> - The lender will expend capital in the form of payment of legal fees for an attorney to review – and, if viable, defend against – the preference action. Attorney fees and costs may also be incurred in the event the lender seeks recourse against the dealership for failing to timely perfect the lien.

RECOMMENDATIONS

<u>Review</u> – A careful analysis of the underlying loan documents (specifically the contract date and perfection date on the title document) will provide lenders with advance notice of a potential preference issue. Simply put, if the lien was perfected more than 30 days after the borrower took possession of the vehicle, a bankruptcy filing within 90 days of the purchase will create a preference issue.

<u>Communication</u> – Lenders should communicate with dealers to ensure that they have procedures in place to timely process purchase documents and title instruments.

<u>Contract</u> – Any agreement between the lender and the dealership should provide the lender with full recourse against the dealer in the event of an untimely lien perfection. The agreement should entitle the lender to recover any fees and costs that it incurs to protect its lien rights in the event a dispute arises over the timeliness of the lien perfection.