Seller Beware: The Contemporaneous Exchange Preference Defense Is Broken

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Several months ago, a trustee sued my client for a small preference, but I learned a big lesson: The "contemporaneous exchange" preference defense embodied in §547(c)(1) is broken. My client was sure everything possible had been done to take advantage of the contemporaneous exchange preference defense in 11 U.S.C. §547(c)(1). There were documents showing that my client and its customer agreed to cash-on-delivery (COD) payment terms. My client's invoices were marked "COD," as were the checks that paid them. There were only two transactions during the 90-day preference period, and both involved my client delivering the goods and, simultaneously, taking ordinary checks from the customer in payment of COD invoices. The first check bounced when initially presented, but it cleared the bank shortly thereafter when presented the second time. The second check cleared the bank the first time.

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The trustee admitted that §547(c)(1) protected my client from preference exposure on the second check, but contended that my client was *ineligible* to invoke §547(c)(1) for the first check because it was initially dishonored. Although the trustee and I settled the case because the dollar amount was too small to warrant litigation, this case taught me that even in the post-*Barnhill*[1] era, the judicial interpretations of §547(c)(1) require the *seller* to take the risk that an ordinary check given in a contemporaneous exchange might bounce. Section 547(c)(1) provides that:

> (c) The trustee may not avoid under this section a transfer—
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> (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
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> (B) in fact a substantially contemporaneous exchange.

Like the other preference defenses, §547(c)(1) is designed to encourage creditors to continue to deal with troubled debtors without fear that they will have to disgorge payments received for value given.

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Last in Line

See Barnhill v. Johnson, 503 U.S. 393, 402, 112 S.Ct. 1386, 1391, 118 L.Ed.2d 39 (1992). The legislative history of §547(c)(1) is incredibly sparse, consisting of the following Official Comment:

> The first exception [§547(c)(1)] is for a transfer that was intended by all parties to be a contemporaneous exchange for new value, and was in fact substantially contemporaneous. Normally, a check is a credit transaction. However, for the purposes of this paragraph, a transfer involving a check is considered to be "intended to be contemporaneous." And if the check is presented for payment in the normal course of affairs, which the Uniform Commercial Code specifies as 30 days, U.C.C. §3-503(2)(a), that will amount to a transfer that is "in fact substantially contemporaneous."

H.R. Rep. No. 95-595, reprinted in 1978 U.S.C.C.A.N., 5963, 6329.

The Uniform Commercial Code section referred to in the Official Comment provided:

> In the case of an uncertified check which is drawn and payable within the United States and which is not a draft drawn by a bank, the following are presumed to be reasonable periods within which to present for payment or to initiate bank collection:
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> a) with respect to the liability of the drawer, thirty days after date or issue whichever is later....

See Kupetz v. Elaine Monroe Assocs. Inc. (In re Wolf & Vine), 825 F.2d 197, 201 (9th Cir. 1987).

At least one court of appeals has held that the specific reference to a 30-day period in the legislative history of §547(c)(1), coupled with a reference to the version of UCC 3-503(2)(a) then in effect,[2] "make it clear that, for purposes of section 547(c)(1), a reasonable time for honoring an uncertified, domestic, personal check is thirty days." *Id.* at 201-202.

Section 547(c)(1) is silent on whether dishonor of a check makes the transfer ineligible for the preference defense embodied therein. However, the sponsors of the legislation in both Houses[3] are often quoted as stating that "payment of a debt by means of a check is equivalent to a cash payment, unless the check is dishonored. Payment is considered to be made when the check is delivered for purposes of §§547(c)(1) and (2)." 124 Cong. Rec. H11,097 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,414 (daily ed. Oct. 6, 1978), as cited in *Tidwell v. Atlanta Gas Light Co. (In re Georgia Steel, Inc.)*, 38 B.R. 829, 833 (Bankr. M.D. Ga. 1984). Even though the last sentence of the sponsors' remarks clearly indicates that the "check delivery date" is the relevant date for purposes of §547(c)(1), the first line of the sponsors' remarks has spawned a line of cases holding that if the debtor pays for a contemporaneous

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[1] *Barnhill v. Johnson*, 503 U.S. 393, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992), which held that the "check clear date" determines the transfer date for purposes of 11 U.S.C. §547(b), but left undisturbed the unanimous opinions of various courts of appeal that the "check delivery date" determines the date of transfer for purposes of the preference defenses embodied in 11 U.S.C. §547(c).

[2] UCC Article 3, which covers commercial paper, was substantially amended in 1990.

[3] Apparently, Rep. Don Edwards, chairperson of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, and Sen. Dennis DeConcini, chairperson of the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary sponsored the bill, and they made identical statements in both Houses.

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transaction by ordinary check and the check bounces, then the transaction is *not* a contemporaneous exchange (irrespective of whether and when the check ultimately clears the bank), and the creditor is *ineligible* to use the §547(c)(1) preference defense. These cases reason that the dishonor of the check creates an "antecedent debt" owed by the debtor and that any subsequent payments to make good the check (no matter how quickly made) constitute preferential payment on antecedent debt. *See, e.g., Goger v. Cudahy Foods Co. (In re Standard Food Servs.),* 723 F.2d 820, 821 (11th Cir. 1984) (cashier's check to replace bounced check was ineligible for contemporaneous-exchange defense); *Morrison v. Champion Credit Corp. (In re Barefoot),* 952 F.2d 795, 800 (4th Cir. 1991) (reasoning that "dishonor of a check, therefore, defeats the actual achievement of a contemporaneous exchange for new value, and we conclude that any payments to make good a bounced check cannot qualify as transfers to which the contemporaneous exchange exception applies").

This line of cases is troubling on several levels. The practical impact of these cases is that the contemporaneous exchange is very risky for sellers who accept an ordinary check as payment. Sellers are safer if they demand cash or wire transfer in advance of the shipment,[4] or insist on a payment for the contemporaneous exchange via cashier's check, certified check, official bank check or money order because the mechanics of these instruments are such that they will not "bounce" due to insufficient funds in the customer's checking account at the moment of presentment, nor can the customer stop payment on them.[5]

This line of cases is also troubling from a legal perspective. The text of §547(c)(1) is silent on the issue of whether a bounced check renders the transaction ineligible for that preference defense, so presumably the courts look to the sparse legislative history for guidance. In the foregoing cases, however, the courts' analysis seems to ignore the purpose and legislative history of §547(c)(1)—especially the Official Comment that indicates that the contemporaneous exchange defense should apply if the check is presented for payment in the normal course of affairs, which that comment defined as 30 days. In my client's case, the check that bounced was, in fact, re-presented and ultimately honored within 30 days. Yet the courts that have considered the impact of a bounced check in payment of a contemporaneous exchange seem to have "grafted" a requirement that the check must be *honored* the first time it is presented in order for the transaction to be eligible for §547(c)(1) protection.

[U]ntil §547(c)(1) is fixed, sellers should not accept an ordinary check from troubled customers on any contemporaneous transaction. Instead, those sellers should insist on a form of payment that cannot be dishonored or stopped by the debtor. Otherwise, the seller may wind up with preference exposure if the check bounces, even if the check is subsequently honored.

These cases are also odd in the aftermath of *Barnhill v. Johnson*. In *Barnhill,* the Supreme Court held that the "check clear date" determines the date of the preferential transfer for purposes of 11 U.S.C. §547(b).[6] The Court specifically *declined* to express any view on the date of transfer for purposes of the preference defenses in §547(c), but noted that every court of appeals to have considered the issue had determined that the "date of delivery" of the check determined when the transfer was made for purposes of §547(c). *See Barnhill,* 503 U.S. at 402, n.9, 112 S.Ct. at 1391, n. 9. The Court's decision in *Barnhill* did not alter the generally-accepted rule that the "check delivery date" determines the check transfer date for purposes of §547(c).

Some post-*Barnhill* decisions have continued to graft an additional precondition on the "check delivery date" rule for purposes of §547(c). They require that the check must clear the bank the first time it is presented—which means that the "check delivery date" rule starts to look a whole lot like the "check clear date" rule. *See, e.g., Stewart v. Barry County Livestock Auction Inc. (In re Stewart),* 282 B.R. 871, 874 (B.A.P. 8th Cir. 2002); *Littleton v. Hinton (In re Triple H Auto & Truck Sales Inc.),* No. 08-1027, 2009 WL 348858, at *6 (Bankr. S.D. Ala. Feb. 2, 2009) ("When a check bounces, the transaction becomes a credit transaction and is no longer viewed as a contemporaneous exchange."). Despite the Official Comment to §547(c)(1) and the 30-day window within which payment is supposed to be considered contemporaneous, even post-*Barnhill* decisions appear to hold that initial dishonor of the ordinary check renders the transaction ineligible for §547(c)(1) protection.

Perhaps Congress will fix §547(c)(1) by making its two elements disjunctive rather than conjunctive. In the Bankruptcy Reform Act of 2005, Congress tried to make the ordinary business defense embodied in §547(c)(2) more "user friendly" for preference defendants by "unlinking" the second and third prongs of the defense. If Congress repairs §547(c)(1) in the same fashion, then transfers that the parties intend to be contemporaneous, and transfers that are, in fact, substantially contemporaneous, will be protected from preference exposure, which is a sensible result. A disjunctive §547(c)(1) would also accomplish Congress' goal of encouraging vendors to conduct "business as usual" with their troubled customers and accept ordinary checks for payment on contemporaneous transactions, and would not penalize the vendor if the customer's ordinary check initially bounces but subsequently clears, or if a replacement check is furnished on a transaction that is intended to be contemporaneous.

However, until §547(c)(1) is fixed, sellers should not accept an ordinary check from troubled customers on any contemporaneous transaction. Instead, those sellers should insist on a form of payment that cannot be dishonored or stopped by the debtor. Otherwise, the seller may wind up with preference exposure if the check bounces, even if the check is subsequently honored. ■

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4 Payment in advance of shipment is not a preference because the plaintiff cannot satisfy the "antecedent debt" element embodied in §547(b)(2).

5 It should be noted that under certain circumstances, a financial institution issuing such checks or money orders may raise its own defense to payments.

6 Justices John P. Stevens and Harold A. Blackmun dissented, and opined that the transfer occurs on the date the check is delivered so long as it is honored within 10 days.

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