

www.kmksc.com

Washington Building
Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, WI 53212
Telephone: 414-962-5110
Facsimile: 414-962-8725

When is a C.O.D. Sale Not a C.O.D. Sale?

Answer: When the check “bounces”. The usual C.O.D. transaction involves a buyer who delivers a check to the seller just before, or simultaneously with, the delivery of the goods. The intent is for the seller to receive the money *before* the buyer gets the goods. Unfortunately, a check is not cash, and all checks are not equal. If the seller releases the goods to the buyer before the check is honored, sometimes a “C.O.D.” sale ends up as an unintended credit transaction should the check in payment “bounce” back to the seller’s bank account.

Common types of C.O.D. payments and their hierarchy of effectiveness follow. The only true C.O.D. payment is the real “cash is king” U.S. currency. The next best thing to cash is a confirmed wire transfer into the seller’s account. A certified check is very close to cash, as once the check is certified the debtor cannot stop payment on the check. A cashier’s check is a check by a bank which is drawn upon itself and is the bank’s promise to pay the seller the amount stated on the check, and the debtor has no right to stop payment.

At times, a buyer may be able to obtain a stop payment on a bank teller’s check or a money order. A teller’s check is a check drawn by one bank upon its account at another bank. Sellers often receive teller’s checks thinking they have received a cashier’s check, because a teller’s check looks like a cashier’s check. A typical teller’s check may show the name of a bank at the top center (e.g. “First National Bank”) and in the left corner show the notation “payable through another bank” (e.g. “The Last National Bank”). The bank which issued the teller’s check for the buyer may, at the request of the buyer, make a stop payment order on the other bank (on which the teller’s check is drawn). The issuing bank continues to be responsible for payment on the check and must pay the check if and when the seller can prove to the bank and/or the court that there was no fraud in the transaction or other breach in the sale contract to justify a stop payment on the check. But this may require a lawsuit.

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There are three basic forms of money orders: 1) a money order drawn on a bank and signed by a bank representative (which may be either a cashier’s check or a teller’s check); 2) a money order drawn by a non-bank (e.g. a convenience store) on its account at a bank (or even drawn on itself), which money order is akin to a teller’s check and is subject to the stop payment issue applicable to a teller’s check; and 3) a personal money order which is in the nature of nothing more than a personal check. A personal money order is drawn on a bank, but it is not the bank’s promise to pay. A personal money order is signed by the buyer and, as such, the buyer can obtain a stop payment order and only the buyer will be liable for the amount of the personal money order.

The buyer's check is the highest risk on the list. Accepting the buyer's check is really accepting a (hopefully) short-term credit transaction. The buyer could, immediately after it delivers the check and takes the goods, stop payment on the check for any reason. Also, the check may be dishonored by virtue of actions of third parties including garnishment of the funds in the debtor's bank account before the check has a chance of being honored, or the debtor may fall in to default with its bank and the bank may freeze or set off the balance in the debtor's bank account, or the debtor may be dumped into bankruptcy – in which case the automatic stay of the bankruptcy case prevents the payment of the check (post-petition payment on pre-petition debts).

Buyers are often put on C.O.D. terms when the prospect of bankruptcy becomes a possibility. The benefits of C.O.D. terms are twofold: the buyer is placed on a very short credit lease (presumably the buyer will be allowed only one chance to bounce a C.O.D. check), and C.O.D. sales give rise to the contemporaneous exchange defense to preference claims under the U.S. Bankruptcy Code. Under the bankruptcy preference laws, basically any payment received by a creditor within the preference period prior to the commencement of the bankruptcy case may be subject to preference attack. However, the Bankruptcy Code provides a "contemporaneous exchange" defense which applies to C.O.D. transactions (so long as the buyer intended a C.O.D. transaction and the check is honored in the ordinary course). The "contemporaneous exchange" defense is a close cousin to the new value defense discussed in our July 1994 article on Preferences. Unfortunately, a contemporaneous exchange defense is placed in jeopardy in the event the C.O.D. check bounces—even if the check is later honored on resubmission or is replaced by a check that is honored. The bankruptcy debtor-in-possession or trustee will argue that the delay in completing the payment destroyed the contemporaneous nature of the transaction.

As discussed above, if the buyer is placed in bankruptcy *before* the check is honored, the seller can expect that the buyer's bank will dishonor the check. The seller should then immediately consider making a reclamation demand for the goods delivered under the aborted C.O.D. sale. The time frame between the C.O.D. delivery to the buyer and the notification that the check has been dishonored and/or the debtor has filed bankruptcy will generally be around four to six days. Consequently, the C.O.D. shipment could fall within the ten-day reclamation window (see our June 1994 article on Reclamation), and perhaps the seller will be able to recover payment for the goods as a priority reclamation claim in the bankruptcy case.

Although credit managers may not always be in position to require C.O.D. terms, the use of C.O.D. terms is an effective and often essential arrangement for sales to a financially distressed buyer, irrespective of the potential risks of accepting payment by check. If the seller wants to "chance" the sale, it may be the only "game" in town, so—"Go for it!!!"

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