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Bankruptcy Court Rejects Bright-Line Rule for Substantially Contemporaneous Exchange

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Bankruptcy Court Judge Kevin Gross, in *In re J. Silver Clothing Inc.*, a 2011 case out of the District of Delaware, rejected an argument that the 10-day (now 30-day) period in Bankruptcy Code Section 547(e)(2) provides a bright-line limit as to whether a transfer is "substantially contemporaneous" so as to fall within the exception to the trustee's preference avoidance powers under Bankruptcy Code Section 547(c)(1). In rejecting the argument made by the Chapter 7 trustee that a transfer perfected after the 10-day period specified in Section 547(e)(2) cannot be deemed substantially contemporaneous as a matter of law, Gross agreed with the majority of federal circuit courts of appeals that have addressed the issue.

Section 547(c) provides that a trustee may not avoid a transfer to the extent that the transfer was intended by the debtor and creditor to be a contemporaneous exchange for new value given to the debtor and the transfer was, in fact, a substantially contemporaneous exchange. Section 547(e)(2) defines when a transfer is made, and provides that one is made at the time the transfer took effect if such transfer is perfected within 10 days after that time; or at the time the transfer is perfected if the transfer is perfected more than 10 days after the transfer took effect. In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) changed "10 days" to "30 days." The BAPCPA amendment is not retroactive and did not apply in this case.

In the complaint, the trustee sought to avoid the debtor's transfer within the preference period of a security interest in substantially all of its assets to the bank. The bank argued that the transfer was a substantially contemporaneous exchange excepted from the trustee's avoidance powers. After determining that the parties intended for the debtor to grant a security interest in the collateral contemporaneously with the bank providing new value in the form of loan funds, the court considered whether the transfer was in fact a substantially contemporaneous exchange.

Due to a problem with the UCC-1 financing statement, the Delaware secretary of state rejected the initial filing and accepted a corrected filing 28 days after the transfer of funds under the loan. The trustee argued that a transfer perfected after the 10-day limit of Section 547(e)(2) could not be substantially contemporaneous. Although the 3rd U.S. Circuit Court of Appeals has yet to address the issue, the 1st and 6th circuits have held that a transfer beyond the 10 days provided for by Section 547(e) is not substantially contemporaneous; the 7th, 8th, 9th and 11th circuits have held otherwise.

Gross agreed with the majority of circuit courts and held that Section 547(e) does not inform the "substantially contemporaneous" requirement of Section 547(c). Instead, he held that the court will look to "the totality of the circumstances, including the reason for the delay, the intent of the parties, and the possibility of fraud" to determine whether an exchange is substantially contemporaneous.

Gross quoted approvingly from a 7th Circuit case that the modifier "substantially" makes clear that "contemporaneity is a flexible concept which requires a case-by-case inquiry into all relevant circumstances (e.g. length of delay, reason for delay, nature of the transaction, intentions of the parties, possible risk of fraud) surrounding the alleged transfer." Gross also agreed with the 8th and 11th circuits that Congress knows how to adopt a specific time limit, but did not do so in Section 547(c)(1). He concluded that not using Section 547(e) as the source of a bright-line rule for Section 547(c) purposes did not render Section 547(e) superfluous, since Section 547(e) serves the purpose of determining when a transfer is made, which must be established in order to ascertain whether the transfer occurred during the preference period and is necessary for a preference analysis regardless of any effect it may have on the interpretation and application of Section 547(c).

In *J. Silver*, Gross held that the 28-day delay between the funding of the loan and the perfecting of the security interest did not disqualify the transfer from being deemed substantially contemporaneous. First, the evidence showed that the parties intended for the transfer to be contemporaneous. Second, the court found the delay in perfection was caused by inadvertent error and was not purposeful. Third, no prejudice resulted from the delayed perfection. No third parties sought to perfect a competing lien on the collateral and no third parties relied on the

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results of a lien search conducted between the time the loan closed and when the lien was finally recorded. Under all the circumstances, the court found the transfer of a lien on the collateral to the bank to have been substantially contemporaneous with the bank's transfer of funds to the debtor.

The 10-day limit is now 30-days as a result of BAPCPA. While *J. Silver* eschews a bright-line test for finding that a transfer is substantially contemporaneous, the better course of action is not to gamble on convincing the court that the totality of the circumstances point to a substantially contemporaneous exchange. Appropriate steps should be taken to perfect the transfer as quickly as possible and within the time period set forth in Section 547(e)(2) so that the transfer is deemed to have been made at the time it actually took effect.

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