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SECTION 547(c) (2) OF THE BANKRUPTCY CODE: THE ORDINARY COURSE OF BUSINESS EXCEPTION WITHOUT THE 45 DAY RULE

by

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Bankruptcy often seems rather harsh on the creditors of a bankrupt debtor.[1] At best, an unsecured creditor will only receive a portion of his claim against the debtor, and he may very well not receive anything at all.[2] This harsh effect is increased by bankruptcy preference law which often requires creditors to return pre-bankruptcy transfers received from the debtor. This is true even if the transfers were accepted in good faith, with no intent to achieve priority over other creditors and with no knowledge of the debtor's insolvency.[3]

For the first time in history, the Bankruptcy Reform Act of 1978[4] provided an explicit exception from preference treatment for certain "ordinary course of business" transfers made during the preference period.[5] As originally enacted, section 547(c) (2) allowed creditors to keep transfers that were: a) in payment of a debt incurred in the parties' ordinary course of business; b) made within 45 days after the debt was incurred; c) made in the ordinary course of the parties' business; and d) made according to ordinary business terms.[6] The "ordinary course" exception was to protect payments on most "ordinary" short-term credit transactions and "leave undisturbed *normal* financial relations" between creditors and debtors.[7] Unfortunately, it failed to accomplish this goal.[8] Forty-five days proved to be too short of a time period to insulate

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[1] *See, e.g.*, Palmer v. Radio Corp. of America, 453 P.2d 1133, 1140-41 (5th Cir. 1971) ("Proceedings in bankruptcy often generate harsh results; indeed the very nature and theory of bankruptcy contemplates injury to some claimants.").

[2] *Cf. id.* at 1140.

[3] *See In re* Teasley, 29 Bankr. 314, 315 (Bankr. W.D. Ky. 1983) (Preference law permits the trustee to yield awesome powers and even, "in effect change the rules after the game is over") A creditor's knowledge of the debtor's insolvency and various other motive or intent elements have historically been required in order for a preferential transfer to be avoided. *See infra* notes 48-67 and accompanying text. The current Bankruptcy Code contains no such requirement. *See infra* note 98 and accompanying text.

[4] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2597 (amended by Bankruptcy and Federal Judgeship Act of 1984 Pub. L. No. 98-353, 98 Stat. 333).

[5] 11 U.S.C. § 547(c)(2) (1982).

[6] *Id.*

[7] H.R. REP. NO. 595, 95th Cong. 373, *reprinted in* 1978 U.S. CODE & AD. NEWS 5963, 6329 (1978); S. REP. NO. 989, 95th Cong. 88, *reprinted in* 1978 U.S. CODE & AD. NEWS 5787, 5874.

[8] *See infra* notes 120-145 and accompanying text.

most short-term credit transactions.[9] In addition, the section was a source of frequent litigation with much of it centering around the 45 day requirement.[10] Apparently because of these and other problems, Congress amended section 547(c) (2) in 1984, removing the 45 day limitation.[11]

The 1984 change expanded the scope of 547(c) (2),[12] but it will not, at least initially, reduce the amount of litigation.[13] This is because the remaining three requirements are dependent upon the meaning that courts attach to the word "ordinary," since it is not defined by the Code.[14] Moreover, since the 45 day requirement was dispositive in most pre-amendment cases, only a small percentage of those cases discussed the three "ordinary course" requirements.[15] Those cases that did reach the "ordinary course requirements" seldom provided much in-depth analysis as to their meaning and scope.

This article will look at some of the principles set forth by case law and provide a more structured method of analyzing cases under section 547(c) (2). In addition, it will examine a few problem areas that are certain to arise in section 547(c) (2) litigation in the near future: (1) Does section 547(c) (2) now protect principal payments on long term debt?; and, (2) will section 547(c) (2) protect a payment to one creditor when all or nearly all other creditors were not paid during the preference period? But before doing so, a short explanation of the Code's definition of preference and a look at the policy and history behind both preference law and the ordinary course exception is in order.

WHAT IS A PREFERENCE?

In general, a preference is a transfer to a creditor that is recoverable by the bankruptcy trustee[16] because the creditor "is deemed to have unduly improved

[9] *See infra* notes 137-143 and accompanying text.

[10] *See, e.g.*, Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 BUS. LAW. 175, 177 (1985).

[11] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended at 11 U.S.C. § 547(c)(2) (Supp. II 1984)).

[12] *See infra* note 149 and accompanying text.

[13] *See* Nutovic, *supra* note 10, at 177 n. 11 ("it can be argued that elimination of the 45 day rule will not decrease the volume of litigation over § 547(c)(2) but will merely shift the litigation focus to the remaining requirements of that subsection").

[14] *Cf.* Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(i), (2) & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 692 (author describes the ordinary course of business and ordinary business terms requirements as "the most opaque requirements to date").

[15] *See, e.g.*, In re Brenton's Cove Dev. Co., 52 Bankr. 287, 292 (Bankr. D.R.I. 1985) ("Unlike the amended statute, former 547(c)(2) included a 45 day rule which was virtually always dispositive, because unless the transfer occurred within 45 days after the debt was incurred, there was no need to consider whether payment was in the ordinary course of business."); *Id.* at 292. *In re* Ewald Bros., Inc., BANKR. L. REP. (CCH) ¶ 70,191 (Bankr. D. Minn. 1984) ("There has been substantial litigation concerning the section 547(c)(2) ordinary course of business exception. Much of it, however, has concentrated primarily on whether the 45 day rule has been satisfied. . . . Few decisions have fully addressed the other elements of the exception. Consequently, just what constitutes the ordinary course of the debtor's and transferee's businesses or ordinary business terms remains somewhat unclear.").

[16] 11 U.S.C. §§547(b), 550 (1982). The trustee's powers are vested in the debtor in possession in a chapter 11

his position to the detriment of other creditors of the debtor's estate."[17] The Bankruptcy Code defines a preference as:

> . . . any transfer of an interest of the debtor in property —
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;[18]
> (4) made —
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between 90 days and one year before the date of the filing of the petition if such creditor at the time of such transfer was an insider;
> (5) that enables such creditor to receive more than such creditor would receive if —
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[19]

The burden of proof is on the trustee to prove the elements of a preference.[20] Given the broad definition provided by the Code, almost any transfer made within 90 days of bankruptcy to an unsecured or undersecured creditor[21] on an antecedent debt is a preference. However, this potentially broad

case and the debtor in possession can bring an action to recover a preference. 11 U.S.C. § 1107(a). Also, "[u]nder appropriate circumstances, a creditor or a creditor's committee may bring an action in the name of a trustee or a debtor in possession." Nutovic, *supra* note 19, at 176 n.8.

[17] Young, *Preferences Under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 221, 222 (1980). "The classic preference situation is that of a privileged creditor — perhaps an insider — with knowledge of and influence over the affairs of the debtor who, seeing that the debtor is sinking in insolvency, gets payment of his debt before the debacle becomes manifest." R. JORDAN & W. WARREN, BANKRUPTCY 317-18 (1985).

[18] A debtor is presumed to be insolvent during the 90 days preceding the filing of the bankruptcy petition. 11 U.S.C. § 547(f) (1982). See Young, *supra* note 17, at 222-23, for a discussion of how this presumption operates.

[19] 11 U.S.C. § 547(b) (1982 & Supp. II 1984). The elements of a preference are basically the same as they were under the old Bankruptcy Act ("1898 Act"). Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 183 (1979). The only major difference is that under the 1898 Act the trustee was required to prove that the debtor was insolvent on the date of the transfer and that the creditor receiving the transfer had reasonable cause to believe that the debtor was insolvent. *See infra* note 65 and accompanying text.

[20] 11 U.S.C. § 547(g) (Supp. II 1984).

[21]
> 11 U.S.C. § 506(a) separates undersecured creditors' claims into two parts: a secured component and an unsecured component. A creditor has a secured claim only to the extent of the value of his collateral. Any remaining balance is an unsecured claim. The effect of § 506(a) is to classify claims, not creditors, as secured and unsecured. In other words, a single undersecured credit has both a secured claim and an unsecured claim. . . ."

Barash v. Public Finance Corp., 658 F.2d 504, 507 (7th Cir. 1981) (footnote omitted). Any payment on an unsecured debt, up to the amount it is unsecured, is potentially a preference. *Id.* at 508. Payments on fully secured debt are not subject to preference treatment because they do not enable the creditor to receive more than he would in a chapter 7 case. *See* 11 U.S.C. § 547(b)(5).

avoidance power is substantially tapered by the exceptions in section 547(c).[22]

POLICY

Probably the most fundamental concept underlying the entire field of bankruptcy is equality of distribution of the debtor's assets among his creditors.[23] "This goal cannot be achieved if a debtor is free to prefer favorite creditors by distributing assets unequally shortly before commencing a bankruptcy case."[24] If such conduct is allowed, bankruptcy distributions would become largely meaningless.[25] Therefore, it is not surprising that "equality of treatment of creditors is the oldest and most frequently advanced goal of preference law."[26] Congress stated that this was one of the two primary goals behind section 547 when it was enacted in 1978.[27]

The other primary goal recognized by Congress was that preference law should discourage creditors from dismembering the debtor prior to bankruptcy.[28] In the weeks and months preceding bankruptcy, creditors often sense that financial collapse is imminent and accelerate their demands so as to collect on their claims before bankruptcy.[29] This so-called "race of diligence" is to be expected and is often a rational decision from the point of view of an individual creditor. He knows that he will likely be paid little or nothing on his claim after the debtor enters bankruptcy. However, such action is not desirable from the

[22] 11 U.S.C. § 547(c). There are currently seven exceptions. A creditor "is protected by each [exception] to the extent he can qualify under each." S. REP. NO. 95-598, *supra* note 7, at 88.

[23] *See, e.g.*, Weintraub & Resnick, *From the Bankruptcy Courts*, 17 U.C.C. L.J. 263, 264 (1985).

[24] *Id.*

> So long as a debtor is solvent, every creditor can expect to be paid in full, and each may act independently without affecting others. There is generally no occasion for collective action. Once the debtor is insolvent, however, payment of one creditor necessarily prejudices others because there are insufficient assets to satisfy all. Bankruptcy, a collective claim enforcement proceeding, appears in the law in response to this kind of potential prejudice. From the creditor's standpoint, bankruptcy's principal theme is equality, or ratable distribution of the debtor's assets, among unsecured creditors. Once proceedings have been initiated, independent collection efforts are forbidden because they run counter to that theme. Because the law leaves initiation of bankruptcy to the parties, however, there may be an interval between the beginning of insolvency and the commencement of bankruptcy proceedings. Although preference law comes into play only after bankruptcy proceedings have been instituted, its focus is on the period between the onset of insolvency and bankruptcy, and its target is a transfer to one creditor during that period.

McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 259-60 (1981).

[25] McCoid, *supra* note 24, at 260-61.

[26] *Id.*

> We can find this notion as far back as the 16th century Case of Bankrupts, . . . in which the court stated ". . . there ought to be an equal distribution . . . but if, after the debtor becomes a bankrupt, he may prefer one . . . and defeat and defraud many other poor men of their true debts it would be unequal and unconscionable, and a great defect in the law. . . ."

R. JORDAN & W. WARREN, *supra* note 17, at 317.

[27] H.R. REP. NO. 95-595, *supra* note 7, at 177-78. *But see* Herbert, *supra* note 14, at 966-67 (arguing that § 547 does not accomplish this goal very well).

[28] H.R. REP. NO. 95-595, *supra* note 7, at 177. *But see* Herbert, *supra* note 14, at 696 (arguing that § 547 does not do a very good job of accomplishing this goal either).

[29] Nutovic, *supra* note 10, at 184-85.

point of view of both the debtor's other creditors and of society as a whole.

The obvious reason for discouraging a race among creditors to collect on their claims before bankruptcy is that doing so will help to maximize the debtor's estate which will be distributed among all creditors.[30] This, of course, is in the best interest of the creditor group as a whole and, to some extent, in the best interest of society.[31]

The less obvious, but more important reason is such action by creditors will without a doubt hasten or even cause the debtor's slide into bankruptcy.[32] "[C]ontinuation of [the debtor's] business is desirable because it may well permit the [debtor] to restructure its operations outside of bankruptcy, thereby avoiding the cost of bankruptcy and ultimately permitting greater payment to all creditors."[33] It is difficult to keep a troubled business afloat if its cash and other assets are being transferred to certain preferred creditors. In fact, it is in society's best interest to prevent bankruptcy in the first place.[34] Many businesses have financial troubles at one time or another, but a relatively small percentage of them ever enter bankruptcy. If the bankruptcy laws in general, and specifically the preference laws, did not "discourage the dismemberment of ailing, but salvageable debtors,"[35] there would be far more bankruptcies. This would clearly not be in society's best interest.

Other possible policies underlying preference law have been proposed from time to time. It has been stated that it is a goal of preference law to "eliminate the incentive to make unwise loans in order to obtain a preferential payment or security."[36] One commentator wrote that Congress intended sec-

[30] McCoid, *supra* note 24, at 261. This is accomplished directly by bringing the preferential transfer back in the estate and indirectly because the value of the estate as a going concern may be greater than the sum of its parts. If the estate is dismantled then it would be impossible to sell it as a going concern. *Id.* In any event, the trustee should have both options available to him.

[31] It is the best interest of society to minimize "costs" of bankruptcy. Bankruptcy "costs" are lower when there is a relatively large distribution to creditors, in relatively equal amounts. Of course, there are costs associated with recovering preferences, such as legal costs and the costs to a creditor who may have acted in reliance on a payment later deemed to be a preference. These must be considered when evaluating the marginal decrease in bankruptcy's cost to society from labeling a certain category of transactions as preferences. But, if the preference laws are clear and both debtors and creditors take them into account when making decisions, the cost of recovering preferences should be negligible.

[32] *Cf.* H.R. REP. No. 95-595, *supra* note 7, at 177.

[33] Herbert, *supra* note 14, at 670. "The House report on the 1978 Act suggests that preference law often allows a debtor to resolve his financial troubles through cooperation with his creditors." McCoid, *supra* note 24, at 261 (discussing H.R. REP. No. 95-595, at 177).

[34] It can be perssuasively argued that this is society's most important goal with respect to bankruptcy law. *But cf.* Ross, *The Impact of Section 547 of the Bankruptcy Code upon Secured and Unsecured Creditors*, 69 MINN. L. REV. 39, 45 n. 12 (1984). Ross notes that it may be desirable in some cases to have secured creditors "police" debtors, and "pull the plug" when things get bad. This prevents the accumulation of substantial unsecured, and probably unpaid, debt. Stopping such accumulation of debt is no doubt desirable, but filing an involuntary petition, rather than dismantling the debtor, is probably the best (and proper) method of policing the debtor.

[35] Ross, *supra* note 34, at 45.

[36] *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. DOC. NO. 137, 93d Cong.,

tion 547 to allow for the redistribution of money from secured to unsecured creditors.[37] A group studying Canadian bankruptcy law felt that preference law "indirectly encourages a higher level of commercial morality and a greater confidence in the credit system."[38] While these goals may have merit, Congress did not mention them when enacting section 547, so it must be assumed that they are, at best, secondary goals of preference law.

Besides the general preference policies discussed above, the ordinary course exception was enacted to address additional concerns. The main policy behind the ordinary course exception is to prevent preference laws from disturbing normal financial relations.[39] This makes sense when one considers that the purpose of preference law is to discourage unusual action on the eve of bankruptcy that interferes with the bankruptcy distribution.[40] Ordinary course transactions do not do this and, in fact, uphold the preference/bankruptcy policy of avoiding bankruptcy in the first place. If preference law applied to pre-bankruptcy ordinary course of business transactions, few creditors would extend credit to troubled debtors; and without credit, few troubled debtors could continue in business. Section 547(c) (2) encourages creditors to extend credit to financially troubled debtors.[41] It strikes a balance between the need to discourage unusual action and the troubled debtor's need to receive credit in order to continue in business and, hopefully, turn his troubles around.

The next section will discuss the history of preference law in order to see how it developed and to see how ordinary course transfers were treated under prior law.

1st Sess. 202 [hereinafter *Commission's Report*]. The Commission was appointed by Congress to study bankruptcy law and recommend changes to the 1898 Act. (See *infra* notes 92, 110-112 and accompanying text for a further discussion of the Commission's report.) It stated that this was one of the three goals of preference law. This concept apparently evolved from Daniel Webster's opinion "that repayments to banks should not be protected [by bankruptcy law] as a means of discouraging dubious loans." Tait & Williams, *Bankruptcy Preference Laws: The Scope of Section 547(c)(2)*, 99 BANKING L.J. 55, 63 n.21 (1982). Webster, and apparently the Commission, were afraid that a creditor might make a loan to a troubled debtor that it ordinarily would not make, if the debtor promised him a preference in the event of insolvency. This is probably no longer a fear today because a creditor will demand security, rather than a promise of preference before giving credit. McCoid, *supra* note 24, at 261. And as a practical matter, how do you distinguish between wise and unwise loans? *Id.* Moreover, "in a growing economy some risk taking by lenders may be desirable." Tait & Williams, *supra*, at 63 n.1. In any event, Congress did not list it as a goal of preference law when it enacted § 547.

[37] Ross, *supra* note 34, at 41-42. Congress certainly never explicitly stated this in the legislative history of § 547, although the anticipated effect of the § 547(c) exceptions may have led one to believe that this was an underlying purpose. In any event, § 547 is probably not meeting this purpose, especially since the 1984 amendment to § 547(c)(2). *See* Ross, *supra* note 34, at 55-56, 67.

[38] *Commission's Report, supra* note 36, at 202.

[39] *See, e.g.*, H.R. REP. NO. 95-595, *supra* note 7, at 373.

[40] *See, e.g.*, Nutovic, *supra* note 10, at 186.

[41] *See, e.g.*, *In re* Morris, 53 Bankr. 190, 192 (Bankr. D. Or. 1985). It may be more correct to say that 547(c)(2) does not discourage creditors from extending credit to troubled debtors.

HISTORY OF PREFERENCE LAW BEFORE 1978[42]

Early English bankruptcy law considered bankrupts to be fraudulent.[43] Therefore, it is not surprising that the emergence of preference law in England was tied to the concept of fraud.[44] By the mid-1500's it was a crime for a debtor to preferentially transfer property before committing an act of bankruptcy.[45] However, preferences were originally treated as public rather than private wrongs and remained so until the mid-1700's.[46]

It was not until 1768, in *Alderson v. Temple*,[47] that property preferentially transferred became subject to recapture.[48] In that case, the first judicial definition of a preference was established: (1) there had to be an "intent to prefer on the part of the debtor"; and (2) the transfer had to result in a "wrong" to the other creditors.[49] It is interesting that a transfer was not considered preferential if the creditor sued the debtor first, or demanded that the debt be repaid or even if he threatened the debtor, as long as the threat was without fraud.[50] In 1883, the definition was refined: all payments made with a view towards giving one creditor an advantage over others were preferences.[51] This is basically still the law today in England, with the focus being on the intent of the debtor in making the transfer.[52]

"The first American bankruptcy legislation, the Bankruptcy Act of 1800, neither defined nor prohibited preferences. Preferences were sometimes recaptured, however, on principles drawn from the English decisions."[53] The 1841 Bankruptcy Act defined an avoidable preference as, *inter alia*, transactions "in contemplation of bankruptcy . . . for the purpose of giving any creditor . . . priority over the general creditors of such bankrupts"[54] While this definition is

[42] Several good sources are available which provide a more thorough examination of early English and American preference law. *See* 3 COLLIER ON BANKRUPTCY ¶¶ 60.02, 60.04 (14th ed. 1977) [hereinafter COLLIER]; McCoid, *supra* note 24, at 251-59; Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737 (1970); In re Hall, 4 AM. BANKR. REP. 671, 679-81 (W.D.N.Y. 1900).

[43] McCoid, *supra* note 24, at 250.

[44] *Id.* "Such preference would be a Fraud upon the whole bankrupt laws, and defeat the two main ends of them: . . . the management . . . of the bankrupt's estate [and] [a]n equal distribution amongst his creditors." Worseley v. Demathos, 96 Eng. Rep. 1160, 1161 (K.B. 1758) (*quoted in* McCoid, *supra* note 24, at 252).

[45] COLLIER at ¶ 60.04; McCoid, *supra* note 24, at 251. The debtor faced imprisonment, two hours in the pillory and loss of an ear. *See* COLLIER at ¶ 60.04.

[46] McCoid, *supra* note 24, at 251.

[47] 96 Eng. Rep. 384 (K.B. 1768).

[48] McCoid, *supra* note 24, at 251.

[49] *See* COLLIER at ¶ 60.04.

[50] McCoid, *supra* note 24, at 252.

[51] COLLIER at ¶ 60.04.

[52] *Id.*; McCoid, *supra* note 24, at 252. Likewise, transfers which would otherwise be preferences are still exempted as long as they were induced by the creditor. *See* COLLIER at ¶ 60.04.

[53] McCoid, *supra* note 24, at 253 (footnotes omitted).

[54] Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (repealed 1843); *see also* McCoid, *supra* note 24, at 253. The Act also provided that a debtor who granted such a preference could not receive a discharge. *Id.*

similar to the English definition, there were some differences in the way the statute was applied. First, the courts presumed that a transfer made by a debtor who knew he was insolvent was made in contemplation of bankruptcy.[55] Therefore, it was the effect of the transfer rather than the debtor's motive in making the transfer that was important.[56] Second, an otherwise preferential transfer could not be "saved" just because it was demanded by the creditor.[57] Nonetheless, as in England, the focus was still on the debtor, and not on the creditor's knowledge or motive.[58]

The Bankruptcy Act of 1867 was the first to require any sort of intent or knowledge on the part of the creditor. It required that the creditor have reasonable cause to believe that the debtor was insolvent or in contemplation of insolvency and that the transfer was made in fraud of the bankruptcy laws.[59] And, like the 1841 Act, it required that the debtor be "insolvent, or in contemplation of insolvency" and that the transfer be intended by the debtor to give preference to a creditor.[60] Also, for the first time, the Act limited preference to those transfers made within the four months preceding bankruptcy.[61]

The Bankruptcy Act of 1898 made a somewhat significant change in preference law by eliminating the requirement that the debtor have an intent to give a preference.[62] This remains true today.[63] But, the 1898 Act kept the preference period at four months,[64] and it still required that the debtor be insolvent when the transfer was made and that the creditor have "reasonable cause to believe that [the transfer was intended] . . . to give a preference."[65] This latter requirement was changed in 1910 to "reasonable cause to believe that the . . . transfer would effect a preference."[66] And finally, in 1938, it was changed to "reasonable cause to believe that the debtor was insolvent."[67]

Since the bulk of American preference law cases prior to 1978 arose under

[55] See McCoid, *supra* note 24, at 254-55 and cases discussed therein. *Cf.* COLLIER at ¶ 60.02.

[56] *Cf.* McCoid, *supra* note 24, at 253-54.

[57] *Id.* at 254.

[58] The 1841 Act did exempt good faith payments made more than two months before the filing of the bankruptcy petition. *Id.* at 257, 259.

[59] Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517 (repealed 1878).

[60] *Id.* As with the previous Act, the courts "held that a debtor who was aware of his insolvency and who made a transfer to a creditor, did so with a view towards giving a preference." McCoid, *supra* note 24, at 256.

[61] Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517 (repealed 1878).

[62] Bankruptcy Act of 1898, ch. 541, § 60, 30 Stat. 544 (repealed 1978).

[63] "Generally speaking it is the effect of the transfer rather than the debtors intent, that is controlling." COLLIER at ¶ 60.02.

[64] Bankruptcy Act of 1898, ch. 541, § 60, 30 Stat. 544 (repealed 1978).

[65] *Id.* at 563.

[66] Act of June 25, 1910, ch. 412, § 11, 36 Stat. 838.

[67] Act of June 22, 1938, ch. 575, § 60(b), 52 Stat. 840. COLLIER states that the only situation where this change would make any difference would be when a creditor knew that the debtor was insolvent, but felt that he would turn his troubles around. COLLIER at ¶ 60.52[1].

the 1898 Act,[68] it will be helpful to briefly review how its preference provision operated in practice. This will provide some insight into the reasons behind the major change in preference law in 1978, and show how ordinary course of business-type transactions were treated before section 547(c) (2) was adopted.

Under the 1898 Act, basic elements of a preference were the same as they are today, with two important exceptions.[69] First, the trustee was required to prove that the debtor was insolvent at the time the transfer was made.[70] This was often difficult for the trustee to prove.[71] The second difference was that, as previously mentioned, the trustee had to prove that the creditor had reasonable cause to believe that the debtor was insolvent when the transfer was made.[72] The trustees' power to avoid preferential transfers was significantly diminished by having to prove these two elements.[73]

There were few clear cut rules for deciding when a creditor had reasonable cause to believe;[74] and "to a great extent each case [was] decided on its own facts."[75] The creditor had to have reasonable cause to believe at the time the transfer was made.[76] But, he did not have to have actual knowledge that the debtor was insolvent.[77] A creditor was charged with reasonable cause to believe "when the facts known to him would [have led] a prudent business person to the conclusion that the debtor [was] insolvent."[78]

In general, a creditor was presumed to have acted in good faith in accepting payment on a debt and the burden was on the trustee to rebut this.[79] The

[68] The main reason for this is because the prior Acts were relatively short-lived.

[69] Levin, *supra* note 19, at 183. See *supra* notes 16-22 and accompanying text for a discussion of the current elements of a preference.

[70] *See* 11 U.S.C. § 60(a) (1976). Today insolvency is presumed, 11 U.S.C. § 547(f) (1982), and it is up to the creditor to rebut this presumption. *See supra* note 18. This is, no doubt, a difficult hurdle for a creditor to overcome. In fact, it is probably harder for a creditor to prove the debtor was not insolvent than it was for the trustee, under prior law, to prove that he was insolvent, since the trustee presumably has "easier" access to the debtor's records, etc. As a practical matter, creditors will seldom try to prove that the debtor was solvent at the time of the transfer. Given the realities of most failing debtors, most are probably insolvent during the 90 day period anyway.

[71] Insolvency was defined as the debtor having liabilities greater than his assets, COLLIER at ¶ 60.52[2], and, therefore, was never impossible to prove. But, actually going back through a debtor's books to see if he was insolvent on a particular date is a formidable task, especially in the case of a business debtor. *See, e.g.*, H.R. REP. NO. 95-595, *supra* note 7, at 178. As a practical matter, it was often not worth the trustees' effort to try and prove insolvency unless the transfer was relatively large. See generally COLLIER at ¶¶ 60.30-60.31 for a discussion of how the insolvency element operated under the 1898 Act.

[72] 11 U.S.C. § 60(b) (1976).

[73] *See, e.g.*, H.R. REP. NO. 95-595, *supra* note 7, at 178; Nutovic, *supra* note 10, at 178.

[74] Young, *supra* note 17, at 222. See generally COLLIER at ¶¶ 60.52-60.56 for a more thorough discussion of how the reasonable cause to believe requirement operated.

[75] COLLIER at ¶ 60.52[2].

[76] COLLIER at ¶ 60.56.

[77] *Id.* at ¶ 60.53[1].

[78] *Id.*

[79] *Id.*

fact that a debt was overdue, without more, was not enough.[80] Likewise, a mere suspicion that the debtor was insolvent or a creditor's anxiety over debts that were not paid was insufficient.[81] In fact, creditors often could demand and receive additional security without being charged with reasonable cause to believe the debtor was insolvent.[82] Knowledge of insolvency was often found in cases involving creditors with a close relationship to the debtor.[83] But a family or business relationship, standing by itself, was not enough.[84]

The reasonable cause to believe requirement protected most ordinary course of business transactions. In discussing the treatment of ordinary course of business payments under the 1898 Act, Collier on Bankruptcy states:

> Payments received by a creditor in the ordinary course of business with an insolvent debtor are not necessarily voidable. The acceptance of payments with no special purpose of obtaining advantage over other creditors but in accordance with the creditor's general method of collecting outstanding accounts will not give rise to reasonable cause to believe that the debtor is insolvent.[85]

Thus, an explicit exception from preference treatment for ordinary course of business transfers was unnecessary under the old Act because the reasonable cause to believe requirement insulated nearly all such transactions.[86]

Another method of protecting ordinary course transfers was the judicially created "current expense rule."[87] The rule allowed payments for current operating expenses of the debtor to be exempted from preference treatment.[88] For example, payments for such things as wages, rent, advertising and warehousing expenses were exempted.[89] The rationale behind the rule was that such debts were not antecedent debts.[90] While the current expense rule was no doubt helpful to some creditors, the reasonable cause to believe requirement

[80] *Id.* at ¶ 60.54[1].

[81] *Id.* at ¶ 60.53[2].

[82] *Id.*

[83] See cases discussed in COLLIER at ¶ 60.53[1] n.2.

[84] *Id.* at ¶ 60.54[1].

[85] COLLIER at ¶ 60.54[4] (footnotes omitted).

[86] *In re* Brown, 20 Bankr. 554, 555 (S.D.N.Y. 1982); *see also* Tait & Williams, *supra* note 36, at 57 (reasonable cause to believe "protected most payments to unsecured creditors since . . . the requirement that the trustee prove the state of mind of his opponent [was] nearly insurmountable").

[87] *See* Herbert, *supra* note 14, at 679; *Barash*, 658 F.2d at 510.

[88] Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 202 (1980); COLLIER at ¶ 60.23 ("payments on account of current business expenses incidental to the operation of a business [were] not within the category of preferential transfers"); *Barash*, 658 F.2d at 510-511; *In re* Acme-Durham, Inc., 50 Bankr. 734, 740 (D. me. 1985).

[89] *See* Kaye, *supra* note 88, at 202.

[90] *Id.* Remember, a transfer must be in payment of an antecedent debt in order to be considered a preference. *See* 11 U.S.C. § 547(b)(2).

was the most important means of protecting ordinary course transfers.[91]

1978 BANKRUPTCY PERFORM ACT

The move to amend the Bankruptcy Act of 1898 began in 1970 when Congress appointed a Commission to "study, analyze, evaluate and recommend changes in the bankruptcy laws."[92] By that time there was widespread sentiment that preference law was too complex, did not conform to modern commercial practices, produced unnecessary litigation and generally failed to fulfill the policies it was intended to advance.[93]

One of the major criticisms of the old law was the reasonable cause to believe requirement. A recent article on the subject states:

> First, it was said that reasonable cause to believe was an unnecessary burden to impose upon the trustee in bankruptcy. Invariably, the transferee alleged that he did not know or have reason to know that the debtor was insolvent, thus creating a litigable issue in every case, with the burden of proof resting on the trustee in bankruptcy.[94]

Rather than protecting innocent creditors, it often protected creditors who had knowledge of the debtors insolvency, but against whom the trustee was unable to prove such knowledge.[95] Furthermore, there seemed to be no justifiable reason for treating a creditor who knows he's getting a windfall differently from one who does not know but gets one anyway.[96] Finally, it was noted that the reasonable cause to believe requirement "was designed to prevent the 'race of diligence' but did not consider, and actually interfered with, equitable distri-

[91] There are two reasons for saying this. First, there are very few cases to be found that explicitly applied the current expense rule. (This could, of course, just mean that trustees were aware of the parameters of the rule and did not bring suit in cases that fell within it; however, this is unlikely.) Second, the very nature of the rule (i.e., that it was based on the payments not being on antecedent debt) excludes from its coverage all but very short-term, operating debts. Clearly, payments on long-term, but ordinary debts were usually protected from preference treatment. *See, e.g., Barash*, 658 F.2d at 510 (recognizing that the reasonable cause to believe requirement usually protected such payments).

Several commentators and courts have stated that the current expense rule was the forerunner of § 547(c)(2). *See, e.g.*, Kaye, *supra* note 88, at 201-02; *Barash*, 658 F.2d at 510; *In re* Property Leasing & Management Co., 46 Bankr. 903, 914 (E.D. Tenn. 1985). This may or may not be true. Congress never mentioned it. The rule operated in a manner that is similar to the way in which § 547(c)(2) operated under the 45 day rule. However, the rationale underlying the rule is that the payment was not a payment on an antecedent debt. It is far from clear that this was ever the rationale behind § 547(c)(2), given the inclusion of an explicit exception in § 547 for substantially contemporaneous transfers which protects transfers that are technically antecedent debts, 11 U.S.C. § 547(c)(1), and the 1984 amendment which removed the 45 day requirement.

[92] Nutovic, *supra* note 10, at 178 n.14.

[93] *See, e.g., Commission's Report, supra* note 36, at 204-05; 4 COLLIER ON BANKRUPTCY ¶ 547.03[2] (15th ed. 1981); Young, *supra* note 17, at 221. By that time article 9 of the U.C.C. had been adopted in nearly all jurisdictions. There were major conflicts between it and § 60 with regard to creation and protection of security interests. *See, e.g., Commission's Report, supra* note 36, at 204-210; Levin, *supra* note 19, at 173-74.

[94] Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1165 (1981).

[95] COLLIER at ¶ 60.52[2]; Levin, *supra* note 19, at 184 (reasonable cause to believe meant to protect innocent creditors, but resulted in only the most blatant preferences being avoided).

[96] JORDAN & WARREN, *supra* note 17, at 318.

bution among creditors."[97]

Given all the criticism, it is not surprising that Congress removed the reasonable cause to believe requirement when it adopted section 547 in 1978.[98] This, coupled with section 547's presumption that the debtor is insolvent during the 90 days prior to bankruptcy,[99] left "little . . . , if anything for the trustee to prove in order to avoid [a] preference."[100] This was recognized by both the Commission in its recommendations and by Congress in section 547.[101] Therefore, for the first time in history, specific statutory exceptions were placed into preference law.[102] The effect of the exceptions was not only to mitigate the breadth of the statute,[103] but also to ensure that preference law achieved its policy goals.[104]

One of the exceptions was, of course, the section 547(c) (2) ordinary course of business exception. Insulating ordinary course of business transactions made sense; otherwise, creditors would be reluctant to deal with troubled debtors unless it was on a cash-only basis.[105] After all, it is often easy to tell when a debtor is in financial trouble, but it is difficult to predict if and when he may enter bankruptcy [106] Creditors may very well not extend credit to such debtors if later repayments are subject to preference attack.[107] They "might, however, be willing to extend . . . credit if it could be assured that [they] would at least be able to keep payments timely made."[108] Moreover, such payments do not threaten the bankruptcy distribution scheme.[109]

The genesis of 547(c) (2) was in the Commission's recommendations. Its

[97] Tait & Williams, *supra* note 36, at 58 (citing H.R. REP. NO. 95-595, at 177-79).

[98] Note how, over time, "[p]reference law has moved from a notion of debtor fraud to a standard of absolute liability for a limited period for preferred creditors." McCoid, *supra* note 24, at 259. *See also* Nutovic, *supra* note 10, at 178 n.21 ("The deletion of any requirement of demonstrating creditor knowlege of insolvency is consistent with an historical move away from a test predicated on establishing indicia of culpable intent or bad motives."). The only intent or motive requirement that was left was for transfers to insiders between 90 days and one year before insolvency. 11 U.S.C. § 547(b)(4) (1982). This was removed in 1984. *See* 11 U.S.C. § 547(b)(4) (Supp. II 1984). Thus, preference law is now essentially strict liability.

[99] 11 U.S.C. § 547(f).

[100] Fortgang & King, *supra* note 94, at 1166. Note that the other six preference elements are essentially the same as they were under § 60. *See supra* note 69 and accompanying text.

[101] *See* Fortgang & King, *supra* note 94, at 1166; Nutovic, *supra* note 10, at 180.

[102] *Cf.* Young, *supra* note 17, at 225.

[103] Nutovic, *supra* note 10, at 180.

[104] See *supra* notes 23-35 and accompanying text for a discussion of preference policy.

[105] *See* Herbert, *supra* note 14, at 679. *In re* Morris, 53 Bankr. 190, 192 (Bankr. D. Or. 1985) ("This court believes that the purpose of section 547(c)(2) was to encourage creditors to continue short-term credit dealings with troubled debtors in order to forestall bankruptcy rather than encourage it.").

[106] *See Morris*, 53 Bankr. at 193.

[107] *Id.*

[108] *Id.*

[109] *Cf. In re* Production Steel, Inc., BANKR. L. REP. (CCH) ¶ 70,843 at 88,029 (Bankr. M.D. Tenn. 1985) ("Congress intended § 547(c)(2) to prevent the avoidance of transfers which because of their ordinary character, were not deemed injurious to either the debtor's rights or those of other creditors.").

approach was to exclude certain types of transfers that, because of policy reasons, it felt should be protected. It recommended that:

> Transfers of an aggregate value of less than $1,000 to a creditor not closely related to the debtor during the three-month period are not subject to attack. Most absolute sales and all transfers in payment of debts for personal services, debts for utilities incurred within three months of the petition, and debts for inventory paid within three months of the delivery of the inventory in the ordinary course of debtor's business should not be subject to preference attack.[110]

The Commission also felt that transfers made on debt incurred within five days of the transfer should not be considered as having been made on an antecedent debt.[111] Obviously, the Commission's approach, while not specifically exempting ordinary course payments, protected many such payments.

"The difficulty with the Commission's proposal was that, after one waded through all of the exceptions, the only type of transfer that could be avoided was the payment by a debtor to an installment lender in reduction or satisfaction of a claim for money borrowed."[112] This naturally led to cries of unfairness from banks and other such lenders.[113] After hearings, Congress re-wrote the preference section. The revision became section 547.[114] While the scheme adopted by Congress protects many of the same transactions that the Commissions report recommended protecting, its approach was different. Section 547(c) was aimed more at protecting general categories of transfers, rather than specific types of transactions. And, unlike the Commission's report, it provided a general exception for ordinary course of business transactions — section 547(c) (2).[115]

Congress only briefly discussed section 547(c) (2) in the legislative history of the 1978 Act.

> The second exception protects ordinary course of business (or financial affairs, where a business is not involved) transfers. For the case of a consumer, the paragraph uses the phrase "financial affairs" to include such nonbusiness activities as payment of monthly utility bills. . . . The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference sec-

[110] *Commission's Report, supra* note 36, at 201.

[111] *Id.* at 205.

[112] Fortgang & King, *supra* note 94, at 1166. This is somewhat of an overstatement, but such lenders were hit much harder by this proposal than other creditor groups.

[113] Nutovic, *supra* note 10, at 179; Fortgang & King, *supra* note 94, at 1166. Note that, despite their complaints to Congress, installment lenders were not protected by § 547(c)(2) as originally enacted.

[114] Fortgang & King, *supra* note 94, at 1166-67. After it was re-written, no hearings were held on § 547(c)(2). *Id.* at 1167.

[115] 11 U.S.C. § 547(c)(2).

> tion to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.[116]

Neither the statute or the legislative history defined important terms used in the statute, such as: "ordinary course of business," "ordinary business terms," and when a debt is "incurred." Commentators criticized this and predicted that there would be much litigation regarding the meaning of the terms.[117] There was also some criticism of the scope of the exception in that it apparently would only protect payments on short-term debts.[118] Timely payments on longer term debts would almost assuredly be preferences because of the 45 day requirement.[119]

PROBLEMS WITH THE 45 DAY RULE AND THE 1984 AMENDMENT

The commentators were correct; section 547(c) (2) was the source of considerable litigation, with the bulk of it centered around the 45 day rule.[120] In fact, the application of the 45 day rule was the deciding factor in most cases, with little attention given to the other three requirements.[121]

The biggest problem was determining when a debt was "incurred" for 547(c) (2) purposes. Several choices were arguably available including the contract date, the date goods were shipped or delivered, the invoice date, or the date that the debt was due. Early on, the courts decided that a debt was incurred on the date that the debtor first became legally bound to pay.[122] This added little to the analysis,[123] but rather changed the focus to: When was a debt

[116] H.R. REP. NO. 95-695, *supra* note 7, at 373; S. REP. NO. 95-989, *supra* note 7, at 88.

[117] *See, e.g.*, Young, *supra* note 17, at 228-29; 4 COLLIER ON BANKRUPTCY ¶ 547.21 (15th ed. 1981); Countryman, *Bankruptcy Preferences — Current Law and Proposed Changes*, 11 U.C.C. L.J. 95, 102 (1978), Kaye, *supra* note 88, at 203 (noting correctly that the biggest problem would be with when a debt was "incurred"). For example, is a debt "incurred" on the date goods are ordered, or the date they are delivered, or on the date on which an invoice is sent? *See infra* notes 122-28 and accompanying text.

[118] *See* Tait & Williams, *supra* note 36, at 55 ("Depending on the interpretation of incurred, the 1978 code could, for the first time, allow the trustee to recover timely, good faith payments made to unsecured term creditors as preferences even when the payments are in the ordinary course of business, and made with no knowledge and no unusual action."); Herbert, *supra* note 14; *see also* Kaye, *supra* note 88, at 203 (noting that § 547(c)(2) would not protect most ordinary consumer credit transactions if the 45 day rule was strictly construed because consumer purchases are often made more than 45 days before payment is due).

[119] Although some argued that the rule could be interpreted to include such payments. *See* Tait & Williams, *supra* note 36. To say the least, the courts were unreceptive to such arguments. *See infra* notes 119-132 and accompanying text.

[120] One commentator noted that the 45 day requirement of § 547(c)(2) was "raised three times more frequently than all the other requirements of that subsection combined." Nutovic, *supra* note 10, at 177 n.11.

[121] *See supra* note 15. One commentator, after discussing the possible problems with interpreting "ordinary" as used in § 547(c)(2), stated that "[t]here has been much more concern about this [problem] in the commentaries than in the cases." Herbert, *supra* note 14, at 692.

[122] *See, e.g.*, *Barash*, 658 F.2d at 510 ("Construing incurred to mean when the debtor first became legally bound to pay comports not only with the plain meaning of the word, but also with the fundamental policy of equality of distribution."); *In re* Iowa Premium Service Co., 695 F.2d 1109, 1111 (8th Cir. 1982).

[123] *Cf. In re* Production Steel, BANKR. L. REP. (CCH) ¶ 70,843, at 88,027; Herbert, *supra* note 14, at 681.

legally owing? State law often came into play in deciding this question.[124]

The courts generally held that a debt was incurred on the date that the debtor received the benefit of the goods or services purchased, rather than on the invoice date or due date.[125] However, for some types of debts, even this date was hard to pin down. For example, debts for rent and insurance were generally held to have been incurred on the date each rent installment or premium was due because this was considered the first date on which services were provided for each period.[126] On the other hand, utility debts were often considered incurred on the date the meter was read.[127] For goods shipped from the seller to the buyer, the courts normally looked to Article 2 of the Uniform Commercial Code (UCC) to determine whether the debt was incurred on the date of shipment or of delivery.[128]

With respect to principal payments on installment debts, the courts held that the debt was incurred on the date that the obligation was first entered into, not on the date that each payment was due.[129] Thus, such payments were usually not protected by 547(c) (2).[130] The courts were split on whether interest payments on installment obligations were within the 547(c) (2) exception. Some felt that since interest accrues over time, the obligation to pay it arises at the beginning of each installment period.[131] Other courts felt that 547(c) (2) was only meant to protect short-term debts and, thus, held that both the interest and the principal portion of a debt were incurred when the obligation was first

[124] *See, e.g., In re* Production Steel, BANKR. L. REP. (CCH), at 88,027 (U.C.C. applied). See Herbert, *supra* note 14, at 680-89 for a thorough analysis of the various options for when a debt is incurred.

[125] *See, e.g., In re* Emerald Oil, 695 F.2d 833 (5th Cir. 1983) (debt incurred on date grain company exercised option to purchase grain already in its possession); *In re* Chase & Sanborn, 51 Bankr. 734, 735 (Bankr. S.D. Fla. 1985); *In re* Brown, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982) (credit card debt incurred on date of first charge during each credit period); *In re* Ray W. Dickey & Sons, 11 Bankr. 146 (Bankr. N.D. Tx. 1980) (telephone debt incurred on date first call made).

[126] *See, e.g., In re* White River Corp., 50 Bankr. 403, 406-07 (Bankr. D. Colo. 1985) (rent); *In re* Clothes Inc., 45 Bankr. 419 (Bankr. D.N.D. 1984) (rent); *In re* Advance Glove, BANKR. L. REP. (CCH) ¶ 70,505 (6th Cir. 1985) (insurance premiums).

[127] *In re* Georgia Steel, Inc., 38 Bankr. 839 (Bankr. M.D. Ga. 1984); *In re* Kevdata Corp., 34 Bankr. 324 (Bankr. D. Mass. 1983); *In re* Thomas W. Garland, Inc., 19 Bankr. 920 (Bankr. E.D. Mo. 1981).

[128] *In re* Handsco Distrib., Inc., 51 Bankr. 700 (Bankr. S.D. Ohio 1985) (date goods received); *In re* Chase & Sanborn Corp., 51 Bankr. 736 (Bankr. S.D. Fla. 1985) (date shipped); *In re* Production Steel, BANKR. L. REP. (CCH) ¶ 70,843 (when delivered); *In re* Almarc Manuf., Inc., BANKR. L. REP. (CCH) ¶ 70,720 (Bankr. N.D. Ill. 1985) (date shipped or received depending on contract); *In re* Amex Trading Co., 37 Bankr. 793 (Bankr. W.D. Tenn. 1983) (date shipped).

[129] *Barash*, 658 F.2d 509-11. *Barash* was the seminal case on this point and its analysis was widely adopted by other courts. The *Barash* court stated: "In short, the section 547(c)(2) exception is aimed at transactions which, although they are technically credit transactions, are not intended to remain unpaid for a long time." *Id.* at 511. This made sense at the time, given the 45 day requirement. Does it today? *See supra* notes 266-278 and accompanying text.

See also Tait & Williams, *supra* note 36, at 59-66 (where the authors argue that the due date should be the date incurred in order to protect unsecured installment sellers).

[130] The only way a payment on a long-term installment obligation could receive protection was if the payment was made within 45 days after the obligation was first entered into. Thus, at best only two monthly installments could be protected.

[131] *See, e.g., In re* Ken Gardner Ford Sales, Inc., 10 Bankr. 632, 648 (Bankr. E.D. Tenn. 1981), *aff'd* 23 Bankr. 743 (E.D. Tenn. 1982).

entered into.[132]

The second major problem with the 45 day rule was determining the date on which a payment by check was made. Was it the date that it was delivered or the date that it was honored? The problem arose because in many cases the debtor would deliver the check within the 45 day period, but it would be honored after the 45 day period was over. The courts were split on the issue.[133]

Courts holding that such a payment was valid relied primarily on a statement in the legislative history that a payment by check was the same as a cash payment, unless the check was later dishonored.[134] The courts holding that such payments were not timely relied primarily on the UCC Article 3 concept that a check does not vest the holder with any title or interest to the funds in a checking account until it is honored.[135] The check payment problem was further confused by cases holding that a check was considered paid on the date of delivery for 45 day rule purposes, but not for the 90 day requirement of section 547(b) (4).[136]

In addition to the problems in applying 547(c) (2),[137] there was substantial criticism of the scope of the exception itself. Section 547(c) (2) by its terms necessarily included only short term debt; long-term installment transactions were not covered.[138] Thus, many timely, good faith payments on "perfectly legitimate . . . credit transactions" were considered preferences.[139] Given the 45

[132] *See, e.g., In re* Iowa Premium Service Co., 676 F.2d 1220, 1221-22, *rev'd en banc;* 695 F.2d 1109 (8th Cir. 1982); *In re* Acme-Durham, 50 Bankr. 734, 740-41 (D. Me. 1985). The arguments on both sides of this issue are thoroughly discussed in the majority and dissenting opinions of the two *Iowa Premium Service* decisions.

[133] Holding that a payment by check was made when delivered: Shamrock Golf Co. v. Richcraft, Inc., 680 F.2d 645 (9th Cir. 1982); *In re* Transpacific Carriers Corp., 50 Bankr. 649 (Bankr. D.S.N.Y. 1985); *In re* Dependable Products, Inc., 51 Bankr. 338 (Bankr. S.D. Ohio 1985); O'Neill v. Nestle Libbys P.P., Inc., 739 F.2d 35 (1st Cir. 1984); *In re* Hoover, BANKR. L. REP. ¶ 69,354 (Bankr. W.D. Ok. 1983). Holding *contra: In re* Quality Holstein Leasing Inc., 46 Bankr. 70 (Bankr. N.D. Tx. 1985); *In re* Staveco Electrical Constr. Inc., 48 Bankr. 247 (Bankr. N.J. 1985); *In re* Advance Glove Mfg. Co., 25 Bankr. 521 (E.D. Mich 1982).

[134] The statement was made by Senator DeConcini to the Senate and by Congressman Edwards to the House: "Contrary to language contained in the house report, payments 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 a check is delivered for purposes of Section 547(c)(1) and (2)." 124 CONG. REC. 34000 (1978) (Statement of Sen. DeConcini); 124 CONG. REC. 32400 (1978) (Statement of Cong. Edwards) (emphasis added). This was probably a misstatement; other legislative history clearly limits it to § 547(c)(1). *See, e.g., Advance Glove,* 25 Bankr. at 525-28. See also Herbert, *supra* note 14, at 689-91, for a thorough analysis of when a payment by check is made. Herbert argues that the delivery date should be used "notwithstanding the fact that it has little U.C.C. Logic." *Id.* at 691.

[135] *See* U.C.C. 3-409 (West 1985).

[136] *See, e.g.,* Chase & Sanborn, 51 Bankr. 736 (S.D. Fla. 1985); *In re* Fasano/Harriss Pie Co., 43 Bankr. 871 (Bankr. W.D. Mich. 1984); *see also In re* Isis Foods, Inc., 37 Bankr. 334 (W.D. Mo. 1984) (holding that a check delivered before but honored after the filing of the bankruptcy petition was a post-petition transfer).

[137] Note that the "incurred" and "payment by check" problems would have eventually been worked out by the courts.

[138] *See supra* notes 129-132 and accompanying text. One commentator noted that "unsecured creditors taking payments or obtaining liens within the preference period [were] the most common victims of section 547(c)(2)." Ross, *supra* note 34, at 54; *see also* Tait & Williams, *supra* note 36 (authors argue that it is a necessary and proper goal of bankruptcy to protect installment lenders).

[139] Herbert, *supra* note 14, at 680.

day rule, it was hard to argue that Congress intended for the exception to apply to long-term transactions.[140]

But, section 547(c) (2) did not even adequately protect many short-term credit transactions. Many such transactions are simply not completed within 45 days. The 45 day limit was apparently chosen because it was thought to equal the normal trade credit cycle: goods or services provided throughout the month, billed for at the end of the month, with payment within 15 days of billing.[141] But this does not comport with reality; many industries have billing cycles longer than 45 days[142] and many other perfectly valid short-term credit transactions are not completed within 45 days.[143] Why should a creditor who insists on payment within 45 days be protected, while another who, consistent with industry practice, allows 60 days is not?

Clearly section 547(c) (2) had failed "to leave undisturbed normal financial relations."[144] Ordinary course transactions that had historically been protected were no longer protected.[145] It provided little incentive for anyone to deal with a failing debtor and, in fact, rewarded the creditors that demanded the strictest terms. Moreover, it produced substantial litigation. Thus, it was not surprising that Congress amended the section in 1984.

Arguably, Congress had several options available to it when it decided to amend section 547(c) (2). It could have extended the 45 day rule to 90 or 100 days. This would have protected most truly short-term transactions, but it would have not eliminated the problem of when a debt was incurred or the check payment problem and it would have, again, left long-term creditors out in the cold. The reasonable cause to believe requirement could have been reinstated, along with all the problems associated with it.[146] Or, the entire exception could have been eliminated, but without it, there would be little incentive for anyone to extend credit to troubled debtors. Instead, Congress chose to eliminate the source of most of the litigation and criticism — the 45 day re-

[140] But see Tait & Williams, *supra* note 36, where the authors made such an argument.

[141] *See, e.g.*, *Emerald Oil*, 695 F.2d at 836. This explanation was first mentioned by Levin, who was a staff member of a congressional committee that helped draft the 1978 Bankruptcy Code. Levin, *supra* note 19, at 186. His theory/rationale was widely adopted by the courts. *But see* Fortgang & King, *supra* note 94, at 1167 ("There seems to be no justifiable rationale for the choice of the number 45 as opposed to any other number of days").

[142] *See* Fortgang & King, *supra* note 94, at 1168. They listed, as an example of this, a retail seller of seasonal goods who does not have the cash to pay for goods purchased until several months later. In addition, many industries simply use a 60 or 90 day billing cycle.

[143] Payment on credit card purchases is a good example. Normally, purchases for the entire month are billed at the end of a month. Payment is generally due in 25 days. If something was purchased in the first 10 days of the month, a timely payment on the twenty-fifth day would not be protected by the 45 day rule. The 45 day rule also caused substantial problems in the commercial paper market. *See* Fortgang & King, *supra* note 94, at 1169-70.

[144] H.R. REP. NO. 95-595, *supra* note 7, at 373.

[145] Tait & Williams, *supra* note 36, at 55; *supra* notes 85-91 and accompanying text.

[146] In 1983, the Senate considered a bill that would have reinstated the reasonable cause to believe requirement as well as eliminate the 45 day rule. S. 445, 98th Cong., 1st Sess. 3211 (1983).

quirement. Given the options available, this was probably a wise choice.

However, the 1984 amendment has created much uncertainty. The elimination of the 45 day rule leaves all of the emphasis on the three "ordinary course" requirements. Since very few cases have yet addressed them,[147] it will be some time before the exact contours of the ordinary course requirements are known.[148] In addition, the 1984 change expanded the scope of the exception,[149] but how far? Are payments on all debt, both long and short-term, now protected? If not, where is the line to be drawn? The legislative history of the 1984 amendment provides no help.[150]

The remainder of this article will attempt to define the scope of section 547(c) (2) and provide a framework for analyzing cases that arise under it. The logical place to start is with the principles developed under pre-1984 law.

[147] Except in the most blatant "out of the ordinary course" transactions, courts seldom provided more than a conclusory statement as to whether a transaction was ordinary. For the most part, the 45 day rule was determinative. If the payment was made within 45 days after the debt was incurred, it was protected; if not, it was a preference.

[148] *Cf.* B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 7.05[4], at 7-125 (rev. ed. 1986) [hereinafter BANKRUPTCY LAW MANUAL]. Removing the 45 day requirement "will . . . place a greater emphasis on the troubling task of interpreting and applying on a case by case basis the ordinary course of business or financial affairs concept." *Id.*

[149] *See* Nutovic, *supra* note 10, at 177; Weintraub & Resnick, *supra* note 23, at 266; BANKRUPTCY LAW MANUAL, *supra* note 148, at 7-24.

[150] The legislative history of the 1984 amendment is surprisingly silent with respect to § 547(c)(2). This is no doubt because Congress was spending most of its time making sure that the 1984 amendment corrected the problems created by the *Marathon Oil* and *Bidlisco* cases. The only real mention of § 547(c)(2) was in a question asked by Senator DeConcini to Senator Dole during the floor statements on the 1984 amendment.

> Mr. DeCONCINI: I know that the Senator from Kansas, along with the Senator from South Carolina, was the principal sponsor of this provision deleting subsection (c)(2) of section 547 of the code, and I would like to clarify two point regarding the effect of this change.
>
> Am I correct that the elimination of the 45 day restriction in subsection (c)(2) of section 547 will relieve buyers of commercial paper with maturities in excess of 45 days of the concern that repayments of such paper at maturity might be considered as preferential transfers?
>
> Mr. DOLE: This is correct, assuming that the "ordinary course of business or financial affairs" and "ordinary business terms" requirements are met.
>
> Mr. DeCONCINI: Would there be any doubt that companies that have a need for short-term funds, and investors who wish to purchase short-term obligations, would both be acting in their respective "ordinary course of business or financial affairs" if they were to deal directly or indirectly with each other in the commercial paper market? And would not the payment of a commercial paper note at maturity be in accordance with "ordinary business terms"?
>
> Mr. DOLE: Those understandings are correct. The commercial paper market is an established market, and participants in it would presumably be acting in the ordinary course of their business or financial affairs and on the basis of ordinary business terms.

Floor Statement on H.R. 5174 (P.L. 98-353), 130 CONG. REC. 8887, 8897 (June 29, 1984). This brief exchange provides little, if any, insight into Congress' intent in amending § 547(c)(2).

Note also that there were some hearings held in 1980 and 1981 regarding the problems the 45 day rule was causing in the commercial paper market. *See Preference Section of the Bankruptcy Code S. 3023*, hearings before the Subcommittee on Improvements in Judicial Machinery, Senate Judiciary Committee (Aug. 18, 1980); *Bankruptcy Reform Act of 1978*, hearings before the Subcommittee on Courts, Senate Judiciary Committee 230-74 (April 3, 6, 1981). The elimination of the 45 day rule was obviously meant to do more than just protect the commercial paper market. This is supported by the fact that in 1980 the Senate considered a bill that was aimed solely at protecting the commercial paper market. S. 3023, 98th Cong., 2nd Sess. (1980). If Congress had intended to only protect the commercial paper market, it would have adopted an amendment similar to the one considered by the Senate in 1980.

CASES UNDER PRE-1984 LAW

The term "ordinary," which is used in all three of the remaining requirements of 547(c) (2), is inherently vague, and Congress' lack of guidance as to its intended meaning leaves much discretion to the courts interpreting the requirements.[151] Moreover, given the almost infinite variety of transactions that debtors and creditors enter into, it is difficult, especially at this early date, to categorize the cases that may arise under section 547(c) (2) except in the most general terms. Each case, to a large extent, will have to be decided on its own facts. However, some general principles may be derived from the cases that have been decided thus far.[152]

Most transfers that are denied section 547(c) (2) protection fail because they violate either 547(c) (2) (B) or 547(c) (2) (C), or both.[153] In other words it is the *transfer*, not the underlying debt, that is usually found offensive.[154] But what makes a transfer offensive to 547(c) (2)?

The courts have looked at whether the transaction deviated from normal business practice and, specifically, whether "the debtor or creditor [did] anything abnormal to gain an advantage over other creditors. . ."[155] In determining what is "unusual" or "abnormal" or what "deviates from normal business" practice, the courts have relied heavily on the parties' previous, similar transactions.[156] If they have not done business together before, or have done so only on an infrequent basis, similar transactions between the debtor and creditor and other parties become relevant.[157] Some courts have held that the standards and practices in the parties' industry are important.[158] An ex-

[151] *In re* Economy Milling Co., 37 Bankr. 914, 921-23 (D.S.C. 1983) ("Unfortunately, the legislative history of the Code provides no guidance as to the content of these phrases and, again, since the concept is new to bankruptcy law there is no developed base of case law upon which to draw") *Id.* at 221-22.

[152] A proper analysis of whether a transfer falls within the ordinary course of business exception requires two separate examinations. First, § 547(c)(2)(A) requires that the *debt underlying the transfer* be "incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the" creditor. Second, § 547(c)(2)(B) and (C) require that the *transfer* itself be "made in the ordinary course of business or financial affairs of the debtor and the" creditor and "according to ordinary business terms." Unfortunately, most of the opinions do not explicitly do this. This generally does not cause a problem when examining an opinion because it is usually obvious whether the court found the transfer or the debt or both offensive. However, a problem is created by the courts' failure to segregate out what aspects of a *transfer* violate § 547(c)(2)(B) and what aspects violate § 547(c)(2)(C). Because of this, the following discussion will not attempt to do so, unless the court in the case being examined did. However, the analysis in the following section will distinguish between the two, because the author feels that it is necessary in order to develop a reasoned approach to § 547(c)(2) questions which can be consistently applied.

[153] This paper will refer to the subsections of § 547(c)(2), as renumbered by the 1984 amendments.

[154] This is not surprising because in most situations the debt is already incurred when the impetus for granting or receiving a preference arises.

[155] *In re* Economy Milling, 37 Bankr. at 922.

[156] *See, e.g., In re Production Steel,* BANKR. L. REP (CCH) at 88,029 ("Section 547(c)(2)(C)] implies consistency between other, but similar, transactions between the debtor and the creditor."); *Amex Trading,* 37 Bankr. at 796.

[157] Nutovic, *supra* note 10, at 184; *Economy Milling,* 37 Bankr. at 922. Note that "[a] transaction can be ordinary and still occur only occasionally." *Id.*

[158] *See Production Steel,* BANKR. L. REP (CCH) at 88,030.

amination of a few cases will illustrate the courts' general approach in determining whether a transfer fulfills 547(c) (2) (B) and 547(c) (2) (C).

The court found an "unusual" transaction in *In re Williams.*[159] In *Williams* the debtor purchased a fence from Sears, Roebuck & Co. on credit, with Sears retaining a security interest in the fence. The debtor usually made monthly payments of $26 and occasionally made payments of $50 or $56 when he missed the previous month's payments.[160] However, during the month in which he filed for bankruptcy, he made two payments to Sears of $264.83 and $80.00.[161] Since these payments extinguished the debt, Sears released the security interest.[162] The court had no trouble finding that section 547(c) (2) did not apply to the two transfers. It stated that the final two payments could "hardly be said to follow the ordinary course of repayment established between the parties."[163]

Another case relying heavily on the parties' past dealings is *In re Ferguson.*[164] In *Ferguson,* the bankruptcy trustee sued to recover a transfer of $12,499.32 made to the creditor shortly before bankruptcy which completely satisfied his debt with the creditor.[165] The debtor was a pork farmer who regularly purchased supplies from the creditor. He was billed monthly and was expected to pay by the fifth day of the following month. But the evidence indicated that the debtor's practice was to pay what he could against the debt, usually in increments of $1,000.00[166] It was also shown that the debtor's average account balance with the creditor was seldom substantially reduced by the monthly payments.[167] However, this was not enough. The only unusual aspects of the transfer was that it was rather large in comparison to previous transfers. The court held that the transfer was not extraordinarily large because the two previous transfers were for $5,000 and $16,000.[168] The court also felt that it was not extraordinary for the debtor to pay off the entire debt since he was terminating his business.[169] Thus, the payment was protected by section 547(c) (2).

The analysis in *Ferguson* is somewhat suspect. First, the fact that a debtor is terminating his business should not justify a payment that extinguishes the entire debt.[170] The payment should be viewed in light of a continuing

[159] 5 Bankr. 706 (S.D. Ohio 1980).

[160] *Id.* at 707.

[161] *Id.*

[162] *Id.*

[163] *Id.*

[164] 41 Bankr. 118 (Bankr. E.D. Va. 1984).

[165] *Id.* at 119.

[166] *Id.* at 119, 121.

[167] *Id.* at 119.

[168] *Id.* at 121.

[169] *Id.*

[170] Nutovic, *supra* note 10, at 182, 184-85, analyzes and criticizes this case.

business.[171] If so viewed, the payment in *Ferguson* was not ordinary since the debtor was not in the practice of paying off the entire account. Second, the amount of the payment should be compared to *all* previous payments. The court apparently did not do this; it only noted that the two previous payments were of $5,000 and $16,000. If other payments were normally not that large, then the fact that the final three payments were large is indicative of unusual dealings and should not be used to justify the large amount of the final payment.[172]

Even seemingly minor deviations from the parties' past dealings have been held unusual when combined with other suspect aspects of a transaction. For example, in *In re Ewald Brothers, Inc.*,[173] the debtor was to make a single payment to the creditor on July 25. Instead, it made two separate payments; one on August 1, the other on August 6. The debtor had never split payments before. The court held that "neither payment was made in the ordinary course of the parties' business or according to ordinary business terms," relying both on the fact that the payments were split up and the fact that they were made late.[174]

It is not surprising that the courts have refused to apply the ordinary course exception when the sales and/or credit terms used are different from the parties' past practices. In *In re Production Steel, Inc.*[175] the creditor, after learning of the debtor's financial problems, imposed several additional terms which had not been used in previous transactions between the parties. It required the debtor to secure payment of the debt with a letter of credit, to make a large down payment, and to issue the creditor a post-dated check.[176] The court found that these additional terms caused the transaction to fail under 547(c) (2) (B).[177] It also held that the transaction failed under 547(c) (2) (C) because no evidence was presented to show that these were ordinary business terms in the steel industry.[178] The court also noted that while each term individually may very well have been an ordinary business term, the creditor must establish that using them all together "constitute[d] a transaction made according to ordinary business terms."[179]

Several cases have held that a transfer does not have to be in the form of

[171] *Id.* at 184-85.

[172] *See also infra* note 254.

[173] 45 Bankr. 52 (D. Minn. 1984).

[174] *Id.* at 59. See *infra* notes 190-196 and accompanying text for a discussion of the effect of late payments.

[175] BANKR. L. REP. ¶ 70,843, at 88,026.

[176] *Id.* at 88,029.

[177] *Id.*

[178] *Id.* at 88,030. The court felt that § 547(c)(2)(B) provides a subjective test while § 547(c)(2)(C) provides an objective test. This is a good way to approach these two requirements, which will be discussed in more detail later. *See infra* notes 243-249 and accompanying text.

[179] *Id.*

cash or a check to be considered ordinary. For example, sellers often allow buyers to return unwanted or unused goods in exchange for a credit to the buyer's account. Such a transaction is a transfer that could be voided as a preference. However, if this is an ordinary practice between the parties, the courts have held such transfers to be exempt under section 547(c) (2).[180]

In *W.L. Jackson Manufacturing,*[181] the debtor was a manufacturer of water heaters and water pump tanks which it sold through dealers. The dealers agreed to inspect any defective tanks for the debtor, who would honor any warranty claims by crediting the dealer's open account.[182] The court held that this practice was protected by section 547(c) (2).[183]

A similar problem occurs when a debtor both buys from and sells to a particular creditor. While such parties normally settled their debts in cash or by check, one of them may occasionally pay the other by sending it goods. In *re Amex Trading Co.*[184] the debtor and creditor were chemical brokers who frequently bought and sold chemicals between themselves. During the 90 days prior to the debtor's entry into bankruptcy, the debtor shipped a barge of chemicals to the creditor. The debtor's account (debt) with the creditor was credited by the amount of the chemicals.[185] There was some evidence presented "that this use of credit took place reciprocally between the debtor and the creditor and between the creditor and other[s]."[186] The court held that the transfer was protected by 547(c) (2).[187]

Transactions like the one in *Amex Trading* should be protected if the parties had engaged in similar transactions in the past, especially if they are common in the parties' industry. It is well established that a transaction can occur only occasionally and still be considered ordinary.[188] The fact that the parties have a practice of using more than one method to settle debts should not, without more, prevent one from receiving section 547(c) (2) protection just because the judge feels that it is an "unusual" method of payment. However, one court has shown some displeasure with similar transactions.[189]

[180] *See, e.g., Amex Trading,* 37 Bankr. at 796; *cf. In re* W.L. Jackson Manufacturing Co., 50 Bankr. 498 (Bankr. E.D. Tenn. 1985).

[181] 50 Bankr. 498.

[182] *Id.* at 500.

[183] *Id.* at 505-06. The court so held even though during the 90 days prior to bankruptcy the debtor apparently honored the dealer's claims by sending free tanks, rather than crediting its account. The court did not discuss the distinction. It could be argued that sending free tanks was not in the parties' ordinary course of business. However, the decision is probably correct. There is little practical difference between the two practices; the dealer receives "free" tanks either way.

[184] 37 Bankr. 793.

[185] *Id.* at 795.

[186] *Id.* at 800.

[187] *Id.* at 801.

[188] *See, e.g., In re Economy Milling, Inc.,* 37 Bankr. 914.

[189] *In re* Gold Coast Seed Co., 24 Bankr. 595 (Bankr. App. 9th Cir. 1982). In *Gold Coast Seed* the debtor paid a debt to the creditor by shipping it some grass seed. Both parties were grass seed dealers. There was some

Late payments are often held not to have been made in the ordinary course of business or according to ordinary business terms. For example, in *In re Ewald Brothers,*[190] the trustee sued to recover three payments which were 7, 9, and 12 days late.[191] While the court noted that the debtor's recent payments had become increasingly late, it found that the payments were "outside the parties' established practice of making and accepting payments one or two days after their official due date.[192]

It seems clear that late payments should not be considered "ordinary course" when the debtor normally pays on time. But what if the debtor has established a practice of paying several days (or weeks) after the due date? The court in *Ewald* hinted, in dicta, that it might be possible to prove that the debtor had established a practice of making late payments.[193] But it is hard to argue that such a practice is according to ordinary business terms.[194] The 547(c) (2) (C) requirement was, no doubt, put in to prevent protection when the terms of payment, though normal for the parties, are not accepted practices for most businesses.[195] Regularly accepting late payments is not normal for most businesses and not the kind of conduct Congress intended 547(c) (2) to protect. However, requiring payment exactly on the due date is too much; payments that are made within one or two days of the due date should be protected whether or not the debtor had an established practice of making payment one or two days late. This is not the kind of "unusual conduct" that Congress intended to be excluded from 547(c) (2) protection.[196]

evidence that this type of transaction was "ordinary in the seed trade and in the parties' past dealings." The debt arose from a previous breach of contract by the debtor and the transfer/payment was overdue, both of which are probably sufficient to remove § 547(c)(2) protection. The court held that "the transfer was a simple preference without business justification" and based its decision in part on the fact that the value of the seed transferred was almost an exact offset of the debt. This should not matter if the practice was, in fact, commonly used in the industry and by the parties themselves in past transactions.

[190] 45 Bankr. 52.

[191] *Id.* at 57-59.

[192] *Id.* at 57; *see also In re Gold Coast Seed,* 24 Bankr. 595 (where the court in holding that a transfer was not in the ordinary course of business relied, *inter alia,* on the fact that the payment was almost a week late); *In re* Brenton's Cove Dev. Co., 52 Bankr. 287 (court in denying § 547(c)(2) protection relied in part on the fact that the debt was over six months overdue when an escrow account was set up to secure payment on the debt).

[193] *Ewald Bros.*, 45 Bankr. at 57. A different, but somewhat analogous argument was rejected in *In re* Morris, 53 Bankr. 190 (D. Ore. 1985). There, the trustee argued that it was the debtor's normal course of business to make late payments and, therefore, a timely payment was not in the ordinary course of business. *Cf. In re* Triple A Coal Co., 41 Bankr. 641 (S.D. Ohio 1984).

> While he concedes that some of the debts which Triple A allegedly owes him were incurred outside of the 45 day period, and admits that the business methods of the debtors were unorthodox, he asserts that the helter-skelter fashion in which these debts arose and were paid was simply the debtors' ordinary way of doing business.
>
> We cannot agree, either as a matter of fact or law.

Id. at 645.

[194] 11 U.S.C. § 547(c)(2)(C).

[195] *See infra* notes 261-263 and accompanying text.

[196] It should be noted that "late payment" cases will probably become more common since the 45 day rule has been removed. *See In re* Staveco Elec. Constr. Inc., BANKR. L. REP. (CCH) ¶ 70,502 (Bankr. D.N.J. 1985) (case decided under 45 day rule; the fact that the payment was 50 days late was not mentioned as violating §

The court in *Ewald* also held that a payment by a "NSF" check, which later cleared after being redeposited, was not protected by section 547(c) (2).[197] The court stated that "it is difficult to conceive of an 'ordinary' business practice that includes payments to a creditor by way of NSF checks."[198] Quite clearly, this is the type of unusual action that Congress intended to prevent with preference law.

Another factor which has played a role in 547(c) (2) cases is creditor pressure. Examples of creditor pressure include threats to file a lawsuit, to join an involuntary bankruptcy petition, to foreclose on a security interest or to call on a personal guarantee.

Probably the best example of creditor pressure to date occurred in *In re Craig Oil Co.*[199] There the creditor was asked to join an involuntary bankruptcy petition against the debtor.[200] At the time the debtor was over its credit limit with the creditor, but was making regular, timely payments.[201] After being asked to join the involuntary petition, the creditor contacted the debtor and "suggested" that it could show its "good faith" by making future payments by cashier's check, instead of by corporate check as it had done in the past.[202] The debtor continued to make these "good faith" payments after it quit purchasing from the creditor.[203] The court, relying heavily on the creditor pressure, held that the "payments . . . by cashier's checks were made neither in the ordinary course of [the creditor's] business or [the debtor's] business nor according to their ordinary business terms."[204]

Creditor pressure also played an important role in *In re Brentons Cove Development Corp.*[205] There, the creditor was a condominium owners' association and the debtor was the condominium project developer. When the debt was not paid, the Association filed suit and "after extensive negotiation efforts . . . funds [to cover the debt] were finally escrowed."[206] "This occurred . . . more

547(c)(2)(B) or (C)).

What about early payments when the debtor normally pays on time? An early payment in and of itself should probably not be condemned. But if accompanied by creditor pressure or other unusual action, maybe an early payment should probably be denied protection.

[197] *Ewald Bros.*, 45 Bankr. at 57-58.

[198] *Id.* at 58 n. 14. The creditor had argued that this had happened twice before and, therefore, it was in the parties' ordinary course of business. The court held that there was insufficient evidence to show that it had happened before. But even if the creditor had established that it had happened before, the court clearly would still have denied § 547(c)(2) protection. *See id.* at 58.

[199] 31 Bankr. 402 (M.D. Ga. 1983), order *aff'd* 785 F.2d 1563 (11th Cir. 1986).

[200] *Id.* at 403.

[201] *Id.*

[202] *Id.* In addition, Craig's president and his wife had personally guaranteed the debt. *Id.*

[203] *Id.* at 406.

[204] *Id.* The court was quick to point out "that payment by certified or cashier's check is not outside the scope of ordinary business practice in and of itself." *Id.*

[205] 52 Bankr. 287.

[206] *Id.* at 292.

than six months after the debt was incurred . . . and only four days before the filing of the bankruptcy petition."[207] The court held that the transfer into escrow was a "classic preference" that was not intended to receive protection.[208]

Should creditor pressure, in and of itself, prevent a transaction from falling within the ordinary course of business exception? Probably not. Such pressure should become relevant only when it has resulted in some change in the way the parties do business. Smart creditors pay attention to their debtor's financial condition and if it appears shaky, will make further inquiries and possibly ask for some assurances. Such conduct should not be punished. Section 547(c) (2) protection should only be denied when such "inquiries" or "suggestions" result in terms or conditions that are different from the parties' past dealings. In such cases, the creditor is using pressure to receive preference over other creditors.[209]

In the vast majority of cases, the debt underlying the preferential transfer is "incurred in the ordinary course of business."[210] However, in some cases the lack of "ordinariness" of the underlying debt is the deciding factor. In other cases, the court's displeasure with the debt and the facts surrounding it influences the court's analysis of the other two requirements.

Probably the most blatant example of debts that are not incurred in the ordinary course of business are those arising out of "Ponzi" schemes.[211] The courts feel that such schemes are so inherently fraudulent and unfair that transfers to both organizers and participants of the schemes are not protected by section 547(c) (2).[212] The courts have all noted, no doubt correctly, that Congress did not intend for the exception to apply to such deals.[213]

[207] *Id.*

[208] *Id.* "These facts fit the classic preference situation of a long overdue obligation, pressure exerted by the creditor, and a lump sum payment made shortly before the filing of the bankruptcy petition." *Id.* See also *In re Production Steel*, BANKR. L. REP. (CCH), at 88,029, where the court in holding that 547(c)(2) did not apply, relied in part on the fact that "demand for the balance of the contract price was made before due under the contract and the demand was accompanied by a treat to call upon [a] letter of credit."

[209] Query: Should a creditor who is asked to join an involuntary petition or who holds a personal guarantee of the debtor's president but who is paid on time be protected while most all other creditors are not paid at all? *See infra* notes 279-283 and accompanying text.

[210] U.S.C. § 547(c)(2)(A).

[211]

> A "Ponzi" scheme, as that term is generally used, refers to an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments. Typically, investors are promised large returns for their investments. Initial investors are actually paid the promised returns, which attract additional investors.

In re Independent Clearing House Co., 41 Bankr. 985, 994 n.12 (D. Utah 1984). They are named after Charles Ponzi, "the eponymous architect of the 'ponzi' scheme." *Id. See* Cunningham v. Brown, 265 U.S. 1 (1924).

[212] *See, e.g., In re* Western World Funding, BANKR. L. REP. (CCH) ¶ 70,828 (Bankr. D. Nev. 1985) (insiders, organizers); *In re*, Western World Funding, 52 Bankr. 743 (Bankr. D. Neb. 1985) (investors); Independent Clearing House Co., 41 Bankr. 985 (investors). The courts always find that such transfers violate all three requirements.

[213] "All of these transactions were unusual, extraordinary, and unrelated to any business enterprise whose protection was intended by the drafters of section 547(c)(2)." *Independent Clearing House Co.*, 41 Bankr. at 1014-15.

Corporate repayments of shareholder loans are often held not to be protected when the corporation is chronically undercapitalized or badly in need of funds because of short-term cash flow problems when the loan is made. A good example of this is *In re Fulghum Construction Corp.*[214] In that case the sole shareholder of the debtor regularly advanced money so that it could meet its payroll obligations.[215] The debtor built oil pipelines — a business which requires a large amount of working capital.[216] The court found that the debtor had been undercapitalized ever since the shareholder purchased it.[217] The loan repayments were not given 547(c) (2) protection.[218]

In *In re Arctic Air Conditioning, Inc.*,[219] the wife of the corporation's president made a loan to the corporation so that it could pay back-taxes owed to the IRS.[220] As in *Fulghum*, the corporation was experiencing cash flow problems and intended to pay off the loans with proceeds of work currently in process.[221] The court held that "[n]either the loan nor the repayment thereof was in the ordinary course of business of the debtor and the [wife]."[222]

The *Fulghum* court indicated that the loans were improper because they were not "established financial transactions between a debtor and a lending institution."[223] This goes too far. Loans are often given by entities besides traditional lending institutions and such loans generally do not pose any harm that would justify depriving them of 547(c) (2) protection. Moreover, the fact that a loan is given by a shareholder or other insider should not categorically prevent it from receiving section 547(c) (2) protection. The better view is that only when the business is experiencing cash flow problems should such loans be suspect. In such a case, the proper thing for the shareholder/partner/proprietor to do is to make equity contributions, not loans.[224]

It is important to note that, while the non-arms length nature of such transactions may make them suspect, insider debts are by no means exempt from protection. For example, in *In re Fulghum*, the court held that rental

[214] 45 Bankr. 112 (Bankr. M.D. Tenn. 1984).

[215] *Id.* at 115.

[216] *Id.* at 116.

[217] *Id.*

[218] "These short-term loans were made by the defendant to the debtor in order to allow the debtor to maintain operations despite its capitalization problems. Such transactions are not excepted from avoidance under the "ordinary course of business" exception found within § 547(c)(2)." *Id.*

[219] 35 Bankr. 107 (Bankr. E.D. Tenn. 1983).

[220] *Id.* at 108.

[221] *Id.*

[222] *Id.* at 110.

[223] *In re Fulghum Constr. Co.*, 45 Bankr. at 116 n.4.

[224] The same should be true in other similar transactions, such as where a shareholder rents equipment to a corporation. There are often non-bankruptcy related reasons for doing this (e.g., tax benefits). The fact that the shareholder is not in the business of renting equipment should not matter. *But see id.* at 118 (court relied, in large part, on the fact that the shareholder was in the business of renting similar equipment).

payments to the shareholder for equipment leased to the debtor were protected.[225] The court noted that the shareholder owned a company that leased such equipment and that the rental charge was reasonable.[226] Likewise, reasonable reimbursements to officers, directors and other insiders for such things as medical expenses and business-related entertainment and travel expenses can receive protection.[227]

Another category of debt often held as not having been made in the ordinary course of business is debt which arises from a previous breach of contract. In *In re Kennesaw Mint, Inc.*,[228] the trustee sued to recover payments made to a person who advanced money to the debtor so the debtor could purchase 20,000 ounces of silver for him. The debtor failed to purchase the silver, but paid some of the money back via several transfers during the 90 day preference period. The court rejected the contention that the transfers were covered by 547(c) (2).[229] This is probably a proper result. It is hard to argue that debts created by a breach are incurred in the ordinary course of business. Furthermore, protecting payments made on such debts will not, in all reality, lessen the creditor's disincentive to deal with the debtor that was created by the breach itself.[230]

A few cases have stated that a debt incurred after the debtor has closed its business is not incurred in the ordinary course of business. In *In re Peninsula Roofing & Sheet Metal, Inc.*,[231] the creditor/attorney refused to do any further work until he was paid for past services. The debtor then assigned some accounts receivables to the attorney. When the receivables were paid the attorney used some of the proceeds to pay off the accumulated debt and put the

[225] 45 Bankr. at 118.

[226] *Id.*

[227] *See In re* Top Sport Distrib., Inc., 41 Bankr. 235 (Bankr. S.D. Fla. 1984). As to such payments the court stated:

> The payments and reimbursements appear to have been part of a well established, continuous, ordinary and reasonable business practice of TOP SPORT for at least five (5) years prior to the bankruptcy proceeding. TOP SPORT's obligation to pay these expenses was incurred in the ordinary course of its business. The expenses were paid currently, in the ordinary and normal course of its business under ordinary business terms. . . .

Id. at 239.

[228] 32 Bankr. 799 (N.D. Ga. 1983).

[229] *Id.* at 805. This is a good example of a case where the court did not explicitly state that the debt was not incurred in the ordinary course of business because it arose out of a breach. But, it is obvious from the tone of the opinion that the court felt that way. It noted that "[t]he ordinary course of business of the debtor was refining and selling process metal," implying that it was not his ordinary course of business to breach contracts. *Id.*

See also In re Gold Coast Seed, 24 Bankr. 595 (where a breach caused the underlying debt, but the court relied on other factors in holding that section 547(c)(2) did not apply).

[230] Of course, just because the underlying debt involved a breach which was later cured does not exempt a transaction from § 547(c)(2) protection. *See In re* Nepsco, Inc., 49 Bankr. 152 (D. Me. 1985). In *Nepsco*, the creditor shipped goods to the debtor which were rejected as non-conforming. The creditor then shipped conforming goods. The court held that a payment on the conforming goods was protected by § 547(c)(2). *Id.* at 154.

[231] 9 Bankr. 257 (W.D. Mich. 1981).

rest in a trust fund to be drawn on as he performed future services.[232] The court held that the transfer to satisfy the old debt was a preference and rejected the attorney's argument that 547(c) (2) should apply, largely because the debtor had discontinued its business before the services were performed.[233]

Kallen v. Litas[234] is a similar case. There, the debtor's business was destroyed in a fire and the creditor/law firm was retained, on a contingency fee basis, to recover for damages caused by the fire. After the claim was settled, the law firm was paid out of the settlement proceeds. When the trustee sued to avoid the transfer, the attorney claimed that section 547(c) (2) was applicable. The court rejected this, mostly because the court felt that section 547(c) (2) was for "normal trade credit transactions . . . such as the sale of goods by a business supplier on account."[235] The court further justified its decision by noting that the debtor had closed his business before the law firm was hired.[236]

It is unclear as of yet whether this analysis carries forward to other creditors who extend credit after the debtor has discontinued business. It could be argued that this should only apply to attorneys and other parties with a special relationship to the debtor, such as insiders and accountants.[237] On the other hand, there is merit to the position that payments on any debt incurred after the debtor ceases business should not receive protection. First, how can a business which is no longer operating have an "ordinary course of business"? Second, and possibly more important, protecting such payments does not really advance the policies behind 547(c) (2). When the debtor's business is shut down there is no longer any reason to encourage dealing with him. Likewise, there are no "normal financial relations" to protect. Of course, in some instances it may be necessary to incur some debt in order to preserve the assets of a business which is no longer in operation. But in most cases, the more reasoned view is that debts incurred after the debtor has closed down are not incurred in the ordinary course of business.

Several cases reveal the necessity of putting on evidence of the parties' previous dealings with each other and of the standards in their industry.[238] This

[232] *Id.* at 259.

[233] *Id.* at 261-62.

[234] 47 Bankr. 977 (N.D. Ill. 1985).

[235] *Id.* at 984. This, in and of itself, is not an adequate justification for the decision. Attorneys and others performing services on credit are entitled to § 547(c)(2) protection.

[236] *Id.*

[237] The rationale for singling out such parties is that they generally know that the debtor is no longer in business, and, in addition, have specific knowledge of the debtor's financial condition. While knowledge, motive and intent are no longer elements of preference law, they are and should be considered when determining whether a debt or transfer is "ordinary."

[238] *See, e.g., Production Steel,* BANKR. L. REP. (CCH) at 88,030 (where the court denied that a transaction was made according to ordinary business terms entirely because the creditor had not put on evidence as to the standard business terms in the parties' industry); *Economy Milling,* 37 Bankr. 914, 921-22 § 547(c)(2) was held not applicable because no ordinary course evidence was presented, even though the court stated that such a showing would have been easy to make); *In re* Super Market Distributors Corp., BANKR. L. REP. (CCH) ¶ 68,896 (Bankr. D. Mass. 1982) (evidence presented held insufficient).

should be done even if the debt, transfer and terms are all obviously ordinary as between the parties and within the industry.[239] Most courts have held that the parties' testimony as to the "ordinariness" of a transaction is sufficient.[240] However, some courts have shown some hostility to labeling a transaction which appears somewhat unusual as "ordinary." Thus, when the transaction may appear to an outsider as being unusual or involves a large sum of money, use of "expert" testimony is probably best, even if it is only the testimony of another member of the industry.

In addition to the various factors listed above, courts have relied on several other factors in denying 547(c) (2) protection.[241] However, one of them alone, if relatively minor, may not be enough to prevent the transaction from being "ordinary."[242] But, the combination of several minor problems is usually enough to deny protection. In the final analysis, it is the quality, not the quantity, of the negative factors that should determine whether a transaction receives section 547(c) (2) protection.

SECTION 547(c) (2) ANALYSIS: SOME SUGGESTIONS

The biggest criticism of 547(c) (2) cases lies with the lack of structure in the analysis of the ordinary course requirements. Most of the cases seem correct in that they generally uphold Congress' intent. However, the courts seldom identify which aspects of the transaction violate which ordinary course element, and frequently do not even identify which element was violated. In addition, few courts state whether the specific elements are to be measured against an objective or subjective standard, or both. The following discussion will provide some suggestions for analyzing future cases.

The first step is to decide whether each ordinary course requirement provides a subjective standard, an objective standard, or both an objective and a subjective standard, against which to measure the transaction in question. There is little doubt that Congress intended for potential 547(c) (2) transfers to be judged both objectively and subjectively. It would be difficult to "preserve normal financial relations" without relying primarily on the parties' past con-

[239] *See Economy Milling*, 37 Bankr. 914. In *Economy Milling* the creditor, a grain elevator company, exercised an option to purchase grain already in its possession. It then made two $1,000 payments for the grain to the creditor/farmer during the preference period. This was more than likely a common transaction for the elevator and the farmer, but the district court upheld the bankruptcy court's determination that neither the debt nor the transfer were incurred in the ordinary course of business. The district court stated that such a showing would have been easy to make.

[240] *See, e.g., Amex Trading Co.*, 37 Bankr. at 799-80 (the only such testimony was that of the debtor and creditor's employees).

[241] A good example of this are the three transfers which were denied protéction in *Ewald Bros.*, 45 Bankr. 52. One of the transfers was made by a NSF check, which was later honored. The other two were made by split payments. All three were late. The court relied on all of the factors in rendering its decision.

[242] For example, split payments, the last of which is only one or two days late, may be protected.

duct.[243] Of course, some transactions clearly were not intended to receive 547(c) (2) protection, no matter how ordinary they are to the parties.[244] Thus, an objective standard is also needed. The question is: What standard does each element require?

The court in *In re Production Steel*[245] felt that 547(c) (2) (B) provides a subjective standard, while 547(c) (2) (C) provides an objective standard. Section 547(c) (2) (B) states that the payment must be made in the "ordinary course of business *of the debtor and the transferee [i.e., creditor].*"[246] Given its focus on the *parties'* course of business, it is proper to consider it as setting out a subjective test. In contrast, the failure of section 547(c) (2) (C) to mention the parties when it speaks of ordinary business terms indicates that it is an objective standard.[247] It could be argued that section 547(c) (2) (C) contains both an objective and a subjective element. However, the parties' "ordinary business terms" are easily included within their "ordinary course of business or financial affairs." Any further distinction is unnecessary; having one element focus subjectively on the transfer, while the other looks at it objectively is less confusing and leads to a clearer analysis.

Section 547(c) (2) (A) requires that the debt be "incurred . . . in the ordinary course of business or financial affairs of the debtor and the transferee."[248] Based on the previous paragraph, it would appear logical to conclude that it provides only a subjective standard. However, existing case law is to the contrary. Take for example the cases involving "Ponzi" schemes. The debts in those cases were not denied protection because they were not "ordinary" for the parties. Rather, the courts felt that they were not the type of debts that Congress meant to insulate from preference treatment; they were not ordinary from an objective standard. Likewise, some debts have been held not to be "ordinary" from a subjective viewpoint (e.g., debts arising from a previous breach of contract). Thus, section 547(c) (2) (A) contains both objective and subjective elements.[249]

The next step is to determine how the elements are to be applied in a given case. Since, in most cases, it is the transfer and not the debt that is in question, the following discussion will focus primarily on 547(c) (2) (B) and 547(c) (2) (C),

[243] Most of the cases thus far have been decided almost exclusively by comparing the transaction in question with the parties' past transactions.

[244] For example, debts arising out of Ponzi schemes. *See supra* notes 211-213 and accompanying text.

[245] BANKR. L. REP. (CCH) ¶ 70,843.

[246] 11 U.S.C. § 547(c)(2)(B) (emphasis added).

[247] *But see Craig Oil*, 31 Bankr. at 402 ("[t]he Court finds that Craig's payments to Marathon by cashier's checks were made neither in the ordinary course of Marathon's business or Craig's business nor according to *their* ordinary business terms."). *Id.* at 400 (emphasis added).

[248] 11 U.S.C. § 547(c)(2)(C).

[249] Logically, this does not make much sense when compared with the discussion in the previous paragraph of the text and with the similar language in § 547(c)(2)(B). But, from a practical viewpoint, it is hard to argue that § 547(c)(2)(A) should not contain an objective element.

although the concepts, for the most part, will apply to 547(c) (2) (A).

As mentioned, 547(c) (2) (B) looks at the parties' past conduct. This makes sense. Congress decided that "normal," ordinary transactions are to be protected from preference attack; unusual transactions are not. The primary method of determining whether a transaction is normal is to look at past dealings. Transactions which do not conform to past dealings are "unusual" and should not be protected. If the parties have previously done business with each other, then those transactions should be examined to see if the present one is within their ordinary course of business.[250] If not, then the parties' past dealings with other, similar parties should be the benchmark.[251] But how close should the transfer at hand be to past transactions?

Thus far, most courts have been relatively strict and required that the transaction closely conform to past dealings.[252] This is proper. Remember that since intent and bad motive are no longer preference elements, virtually all transfers on antecedent debt made within 90 days of bankruptcy are subject to preference attack. Section 547(c) (2) was meant to taper this in order to protect ordinary course transfers, which historically had been protected by the "reasonable cause to believe" requirement. But, if the exception is too broadly applied, preference law will become largely meaningless. Thus, strict compliance is proper, if not essential, to ensure that the policies behind preference law are upheld.

For example, if the debtor is normally billed on the first of the month and pays on the tenth (the due date), then the court should require payment by the tenth or eleventh. Likewise, if in the past the debtor was always given 30 days to pay and paid with a corporate check, then a change to payment by cashier's check within 10 days should not be considered as ordinary.[253]

The harder questions arise when the parties' previous dealings are not so exact. How much latitude should the court allow? In general, if the parties' past conduct varied, but had ascertainable, reasonable boundaries, then the court should consider any transaction that falls within those boundaries as ordinary. For example, assume that the debtor is an electrical contractor and the creditor is an electrical supply company. The debtor purchases supplies on credit as needed for each project he is working on. He pays for all supplies pur-

[250] This is not to say that the parties can receive protection by establishing a totally random, haphazard course of business and showing that the transaction in question fell within it. *Cf. Triple A Coal Co.*, 41 Bankr. 641, 645. Such conduct is policed by § 547(c)(2)(C). Section 547(c)(2)(B) just establishes that the transfer was within the parties' past conduct.

[251] Examining dealings with third parties does not remove the subjectivity of the test. It is still looking at how *this creditor* deals with his debtors and how *this debtor* deals with his creditors.

[252] This will no doubt continue, since the section has otherwise been broadened by the removal of the 45 day requirement.

[253] Given this scenario, early payment by means of a cashier's check is indicative of the kind of "unusual action" Congress intended to prevent. *Cf. Craig Oil*, 31 Bankr. 402 (discussed *supra* at notes 199-204).

chased for a project within two weeks of completion. Since some projects take only a few days and others may take months, the time between purchase and payment necessarily varies. Yet, any payment within two weeks of completing the project that the payment relates to should be considered ordinary.[254]

Does this analysis extend to situations like the one in *In re Ferguson?*[255] In that case, the debtor was a pig farmer who regularly purchased supplies on credit from the creditor. The creditor billed him at the end of the month, and payment was to be made on a set date in the following month.[256] In practice, however, the debtor paid what he could against the debt, usually in increments of $1000.[257] The payments would seldom coincide with the purchases made in the previous month and seldom reduced the debt by a substantial amount.[258] In addition, the debtor would occasionally make two or three such payments a month.[259] Under such circumstances, should any payments to the creditor within the preference period be protected by 547(c) (2)?

The first question is whether a payment under such a practice is objectively ordinary under 547(c) (2) (C). One's gut-level feeling is to say no; the entire bill was to be paid during the month following the purchases and not doing so simply takes it out of the "ordinary" category. However, many businesses operate this way. In fact, most of the debtors of the creditor in *Ferguson* probably had payment practices similar to this. The creditor is in effect extending a continuing line of credit to the debtor. It is in his best interests to have credit terms that require payment in the month following purchases. But he should not be penalized for extending continuing credit when this is part of a practice that has been long established between the parties. The real problem is to determine if the parties' past practice had reasonable and ascertainable boundaries. If so, and the transfers in question fell within them, then it should be protected. However, if past conduct was so random and haphazard that it yields no reasonable, ascertainable boundaries, then the transfers should not be considered ordinary.[260]

The big problem with section 547(c) (2) (C) is determining what the benchmark for the objective standard should be. Business practices in general? Prac-

[254] However, the court should be careful in defining the boundaries of past conduct. Unusual dealings brought upon by the possibility that the debtor may enter bankruptcy may occur before the 90 day preference period begins. After all, the parties, especially the creditors, do not know exactly when the debtor will enter bankruptcy. If unusual actions prior to the preference period are used to determine the parties' ordinary course of business, then the court may end up protecting payments that were not meant to be protected. See *Ferguson*, 41 Bankr. 118, where the court may have done just that. See *supra* note 172 and accompanying text which discuss this aspect of *Ferguson*.

[255] 41 Bankr. 118. See *supra* notes 165-172 for a more complete discussion of this case.

[256] *Id.* at 221.

[257] *Id.* at 119, 221.

[258] *Id.* at 119.

[259] *Id.*

[260] *See supra* paragraph of text accompanying note 254; *cf. Triple A Coal Co.*, 41 Bankr. 641.

tices in a particular industry?[261] If so, which party's industry? And, how does one define the industry? This could be a problem for the courts. In most cases, however, general business practices should be the standard.

For the most part, 547(c) (2) (C) was put in to ensure that the parties' course of dealing lived up to general business practices. It prevents a creditor from arguing that it was in the parties' ordinary course of business for the debtor to make late payments, or to pay whenever he felt like it. After all, 547(c) (2) is to protect normal business practices; Congress felt that there was no need to protect "unorthodox" or "helter skelter" business transactions.[262] But if the parties' practice is within generally accepted business practices and is an established part of the parties' dealings, there should be no need to examine industry standards.

There are several reasons for not generally requiring proof of the business terms in a particular industry. As indicated above, just choosing and defining the relevant industry would be a considerable task in many instances. Then, once an industry was chosen, a large amount of proof would usually be required to show the industry standards. And in most cases, it would be found that there is no one standard; the industry practices are varied and the parties' conduct fell well within accepted norms. Most importantly, why should the creditor be forced to prove that the parties' business terms conformed to the industries' when they have been doing business together for years, on terms which are reasonable in light of general business practices?

In addition, most non-ordinary business terms that surface in the cases are non-ordinary in a general business or practice sense. It is not normal for a debtor to make late payments, even if the creditor can establish that this was the normal practice. Likewise, it is not an ordinary business practice for a creditor to threaten to join an involuntary petition against the debtor or to call on a personal guarantee of the debtor's president if he is not given preference over other creditors. No industry standard is necessary to show that these are not ordinary business terms.[263]

In some situations, however, industry standards will be relevant. If the terms used appear unusual or were used only occasionally by the parties, then it may be necessary to look at industry practices. In such a case, the court may wish extra assurance that the transaction was "ordinary" and not an unusual action being camouflaged as ordinary. A good example of this is *In re Amex*

[261] The court in *In re* Production Steel, Inc., BANKR. L. REP (CCH) ¶ 70,843, required this.

[262] *E.g.*, *In re* Independent Clearinghouse, Inc., 41 Bankr. 985 (Ponzi scheme); *In re* Triple A Coal, Inc., 41 Bankr. 541 (involved poor, haphazard recordkeeping and substantial insider wheeling and dealing, that bordered on fraud). In such case, there is no need to rely on an industry standard to determine that § 547(c)(2) does not apply.

[263] But it would be wise to have the creditor testify that the transaction was in accord with industry standard if, in fact, it was. *See supra* notes 238-240 and accompanying text.

Trading Co.[264] where the parties normally paid debts with cash, but the transfer in question was a payment of goods (a barge of chemicals). Both parties were chemical brokers and the creditor put on evidence that they had settled debts in this manner in the past. In addition, the creditor introduced evidence that such a transaction was a standard practice among chemical brokers. The court held that the transfer was protected by 547(c) (2). But without the industry evidence, it could have concluded that the taking of goods in payment of a debt when cash was usually used was nothing but an attempt to obtain preference over other creditors.

Another situation where an industry standard will be important is when the parties have not previously done business together. In such a case, the parties' normal business practices with other creditors and debtors, as well as industry standards, will be relevant to proving 547(c) (2) (B) and 547(c) (2) (C).[265] However, when the parties have a history of dealing together, then that should be the primary focus, with the ordinary business terms requirement only striking down transfers that are contrary to general business practices (e.g., late payments).

Obviously, section 547(c) (2) leaves a lot of discretion to the bankruptcy court. It must determine that the underlying debt is "ordinary" and the transfer conforms to general business practices. Then it must determine the boundaries of the parties' past dealings and see if the transaction at hand falls within the boundaries. But this does not imply inconsistent decisions. For the most part, the cases thus far have been consistent in result, though not in approach. And as more cases are decided, a consistent framework of analysis will develop, hopefully encompassing the suggestions outlined above. At this point in time, it would not be helpful to examine the almost infinite variety of hypothetical situations that could arise, given the fact-specific nature of 547(c) (2) cases. However, two issues that need to be addressed are: (1) Does 547(c) (2) now cover principal payments on long-term debts? (2) Should a transfer receive 547(c) (2) protection when most, if not all, other creditor's are not paid during the period preceding bankruptcy?

ARE PAYMENTS ON LONG-TERM DEBT PROTECTED?

One of the biggest questions arising from the 1984 amendments is whether section 547(c) (2) now applies to payments made on long-term debt. The 45 day rule necessarily limited it to payments on short-term debt. With that requirement gone, however, the statute on its face applies to payments on all debt, both long-term and short-term. Some commentators have stated that it should still be applied only to payments on short-term debt.[266] However, the

[264] 37 Bankr. 793 (discussed *supra* at notes 184-189 and accompanying text).

[265] *See* Nutovic, *supra* note 10, at 184.

[266] Duncan, *Loan Payments to Secured Creditors as Preferences Under the 1984 Bankruptcy Amendments*, 64 NEB. L. REV. 83, 87-91 (1985).

legislative history contains no express statement which limits 547(c) (2) to short-term debt, and applying it to payments on all debt is more consistent with the policies behind the section. Thus, the more reasoned view is that it should apply to payments on both long-term and short-term debt.[267]

As mentioned, the legislative history behind the 1984 amendment to 547(c) (2) is practically non-existent, and thus, is no real help in determining whether Congress meant to protect payments on long-term debt.[268] Therefore, an examination of whether protection of such payments supports the policies behind 547(c) (2) is in order.[269]

First of all, avoidance of timely payments of long-term debt definitely interferes with "normal financial relations." To the extent that such payments are avoided as preferences, normal financial relations suffer. Moreover, how do you define short term? Six months, one year, two years? The line between short term and long-term is at best fuzzy. It will no doubt take years for the courts to consistently define short-term and when they do the decision will be little more than arbitrary judicial line drawing. In the meantime, the inconsistency and confusion created will definitely not preserve financial relations.

What about the policy to encourage creditors to deal with troubled debtors? One could argue that long-term creditors do not need encouragement to deal with debtors. Most long-term debtors are already locked in and few, if any, would even give long-term credit to a debtor who appears to be on the verge of bankruptcy. This is true. But what about a creditor who is considering giving long-term credit to a debtor who is having problems, but not on the brink of bankruptcy?

One argument is that such creditors can, and usually do, secure their loans and, thus, do not have to worry about preference laws.[270] However, this is not always possible. In addition, many secured creditors find themselves undersecured when the debtor enters bankruptcy and payments on undersecured debt within the preference period are avoidable. Another argument is that a long-term installment creditor will only have to return three payments as preferences, which is only a small percentage of the total payments that are necessary to retire such a debt. Granted, this possibility is probably not enough to prevent most creditors from giving a loan. It merely increases the creditor's

[267] *See, e.g.*, Nutovic, *supra* note 10, at 186 n.53; Weintraub & Resnick, *supra* note 23, at 264. Both articles express the opinion that § 547(c)(2) now applies to long-term debt. One even called the 1984 amendments a "welcome relief to lenders and other credit grantors." *Id.*

[268] *See supra* note 150 and accompanying text.

[269] Remember, the primary policy of bankruptcy law is equality of distribution of the debtor's assets among his creditors. Preference law ensures that pre-bankruptcy transfers that interfere with this are avoided. Congress determined that ordinary course of business transfers do not interfere with the equality of distribution, and that protecting them supported other important policies of preserving normal financial relations and encouraging creditors to extend credit to troubled debtors. *See supra* notes 23-41 and accompanying text.

[270] Payments on fully secured loans are not preferences. *See supra* note 21.

risk and, thus, the cost of credit to the debtor. But should bankruptcy preference laws be interpreted so as to raise the cost of obtaining credit?

The big problem is not that long-term creditors will not deal with debtors who appear to be on the verge of bankruptcy, but that they may pull the rug out from under one debtor when financial problems arise. An undersecured, long-term creditor who discovers that his debtor is having serious financial troubles may find it to his advantage to foreclose, if the chance to do so arises. Most collateral decreases in value over time, both from wear and tear and from the fact that it just gets older. If he is not being paid (or the payments are subject to avoidance when the debtor enters bankruptcy), it may be best for him to foreclose and limit his loss on the transaction. However, if he can be assured of keeping timely payments and the payments at least equal the amount by which the collateral is decreasing in value, then there is no incentive to foreclose.[271] Hopefully, the debtor will recover and, if not, the creditor is in no worse a position than if he had foreclosed at the first sign of financial trouble.[272]

It could also be argued that a policy of preference law is to maximize the estate and, while payment on short-term debt does not diminish the estate because there is an offsetting contribution to the estate, payment on a long-term debt diminishes the estate because it offers no offsetting contribution.[273] On the surface, this argument has merit; however, on closer examination it, for the most part, fails. First, maximizing the estate was never explicitly stated by Congress as a policy supporting preference law. At best, its a secondary policy. The debtor's estate is to be frozen and maximized from the date the petition was filed.[274] Preference law merely brings in pre-petition transfers that interfere with the goal of equal distribution. Congress has stated that ordinary course of business payments do not interfere with this goal. Second, contrary to what some courts and commentators have stated, Congress never stated that a justification for 547(c) (2) was that such payments involved an offsetting contribution to the estate. The policy underlying 547(c) (2) is to preserve normal financial relations. It is true that goods purchased with short-term credit shortly before bankruptcy are likely to still be in the estate. But so is a piece of machinery that was purchased on credit five years ago. Whether either debt is paid, the items remain in the estate. It is also true that short-term creditors may be more vital to a troubled debtor, and thus, they need an incentive to extend credit. But why deny the long-term creditor payments which were timely made

[271] *Cf. Morris*, 53 Bankr. at 193.

[272] He is in no worse a position because the timely payments hopefully at least equal the amount by which the collateral is decreasing in value. If this happens then his secured position is not deteriorating. Moreover, if the payments exceed the amount by which the collateral is decreasing in value, the creditor is improving his secured position. This is because any payments to an undersecured are credited to the unsecured portion of his loan.

[273] This was the main argument used by one commentator who argued that payment on long-term obligations should not be protected. *See* Duncan, *supra* note 266, at 90.

[274] Nutovic, *supra* note 10, at 186.

in the ordinary course of business?

Policy arguments aside, what did Congress intend? Well, the 45 day requirement was the only part of the statute that limited its effect to short-term payments and it was removed in 1984. One commentator has argued that a short statement in the legislative history of the 1984 Act, ensuring a Senator that the amendment would relieve the problems that the 45 day requirement caused in the commercial paper market[275] indicates that Congress meant for section 547(c) (2) to still apply only to short-term debt. Congress was concerned about that problem and all the other problems caused by the 45 day requirement.[276] But that statement does not even intimate that 547(c) (2) was to be limited to short term transactions. Moreover, in 1980 the Senate considered, but rejected, a bill that would have provided a specific exception to preference treatment for transactions in the commercial paper market.[277]

In short, there were several options Congress could have chosen to eliminate some of the problems the 45 day rule caused without extending protection to long-term debt. But, it did not choose these options. It could have removed the 45 day rule and inserted "short-term" in 547(c) (2). Or it could have changed the 45 day rule to, say, 90 or 100 days. Or, as mentioned above, it could have created a specific exception for commercial paper. But Congress instead simply eliminated the 45 day rule. By doing so, it removed the only element that limited 547(c) (2) to short term transactions. Its choice is clear — payments on all types of debt, both long- and short-term, can be protected. Right or wrong, it made a choice and it is not for the courts to alter it. If Congress decides that it made a wrong choice, that 547(c) (2) takes away too much of the bite from preference law, it is Congress' responsibility to change it.[278]

Is A Payment To One Creditor "Ordinary" When Most Or All Others Are Not Paid?

Another problem which is sure to come up in future cases is whether a timely and otherwise ordinary payment to one creditor is protected by 547(c) (2) when most of the debtor's other creditors are not being paid. Intuitively, it seems that such transfers should not be considered to have been made in the ordinary course of business of the debtor or according to ordinary business

[275] Duncan, *supra* note 266, at 90 n.28. See *supra* note 150 and accompanying text for a discussion of the scant legislative history of the 1984 amendment.

[276] See *supra* notes 120-145 and accompanying text for a discussion of the problems caused by the 45 day rule.

[277] *See supra* note 150.

[278] A remark made by the Eighth Circuit in holding that old § 547(c)(2) applied to interest payments on long-term installment debt is particularly relevant:

> We are not suggesting that there are not countervailing policy considerations. When dealing with reorganization, one creditor's gain is usually another's loss. Congress could decide that banks are less in need of protection than other creditors and legislate accordingly. But a court should not make such a decision absent evidence of a congressional intent to do so, especially when the plain language and usual meaning of the words are clear.

Iowa Premium Service Co., 695 F.2d at 1111.

terms. However, very few debtors can pay all their creditors in the months preceding bankruptcy. When liquid assets are less than liabilities, it is necessary for the debtor to choose which bills must be kept current in order to stay in business. And, since preventing bankruptcy in the first place is an important goal, and since section 547(c) (2) in particular is directed at preserving normal financial relations, the courts should be hesitant in denying a creditor such a payment if it was made in good faith and was otherwise "ordinary."

Nonetheless, it seems unfair and against the policy of equal distribution to allow payments to some creditors while others go unpaid. But, courts have been particularly unresponsive to claims of unfairness in preference cases. And the policy of equal distribution is relative; exact equality is never achieved.[279] In fact, in every case where 547(c) (2) is applied, some other creditors are not paid in full. If all creditors were being paid, then there would be no need for bankruptcy in the first place.

But what about cases where only one or two creditors are paid in the 90 days prior to bankruptcy while the other 10, 20, 30 or 100 creditors are not? When this occurs, the court should be more reluctant in applying section 547(c) (2). Paying two out of 100 creditors is seldom going to do much to keep the debtor in business. It is more indicative of creditor pressure or "bad" motive on the part of the debtor in deciding who to pay.[280] The creditor pressure can be explicit like threatening to join an involuntary petition or to call on a personal guarantee. Likewise, it can be implicit; just the fact that the creditor has a personal guarantee of the debtor's president or sole shareholder covering the debt could cause him to be paid over others.[281] The debtor's "bad" motive could be in paying debts owed to insiders, relatives, friends or pressure creditors while ignoring all other creditors. Where one or more of these factors are present in a case where the debtor paid only a small percentage of his creditors during the preference period, the court should deny section 547(c) (2) protection. Such payments should not be considered ordinary[282] unless it can be shown that the debtor made a necessary and good faith business decision to pay these few over others.

In such a situation, who should have the burden of showing improper

[279] The Bankruptcy Code itself does not even provide for complete equality (e.g., administrative expenses where priority creditors are paid before general creditors).

[280] "Bad" motive is not meant to imply evil or illegal actions, just the type of motive that takes a transfer cut of § 547(c)(2) protection (like only paying your brother-in-law). Note that the debtor and creditor's motive, knowledge, intent, etc., while no longer preference elements, are relevant to a § 547(c)(2) determination. *See supra* note 237.

[281] Another example of implicit pressure is where the president or shareholder of a debtor corporation also does business with the creditor in his personal capacity and wants to continue to do so after the corporation's bankruptcy.

[282] Remember that this section is assuming that the transfer in question is ordinary in all other respects. Bad motive and creditor pressure, both implicit and explicit, should be considered if there are other out-of-the-ordinary aspects of the transaction.

pressure or motive? The creditor has the burden of proving whether 547(c) (2) applies to the transfer,[283] so it might seem proper to make him prove that no such pressure or motive existed. However, this would require the creditor to prove a negative, which is not an easy task. Such a rule would hurt honest, good faith creditors as much as "bad" ones.

A better rule would be for the trustee to have the burden of coming forward with evidence showing pressure or bad motives in cases where very few creditors were being paid. The trustee should also have to put on some evidence that paying the particular creditor was not vital to keeping the business going. The ultimate burden of proof would still be on the creditor and if such a showing was made he would have to bring in evidence proving that the debtor made a rational, good faith decision to pay him over other creditors. This method would place the initial burden on the person who normally has the best access to the records and the best knowledge of the debtor's operations: the trustee or the debtor-in-possession.

One caveat of this should be that when the creditor is an insider or other person with a close relationship with the debtor, he should have to justify why he was paid over others, without a showing of bad motive or pressure by the trustee. All that the trustee would have to show is that only a small percentage of the debtor's creditors were being paid and that this creditor was an insider. In such a case, unlike with unrelated creditors, the debtor is less likely to cooperate with the trustee in showing pressure, etc. Moreover, an insider is likely to have specific knowledge of the debtor's business and should easily be able to prove why he was paid over other creditors.

It should be stressed that in most cases the debtor's good faith decision on who to pay should be respected. Creditor pressure and bad debtor or creditor motive should only be relevant when relatively few creditors were paid or when other out-of-the-ordinary aspects of a transaction are present.

CONCLUSION

It was no doubt hoped that the 1984 amendment would eliminate all of the problems surrounding section 547(c) (2). Unfortunately, the amendment has just substituted one set of problems for another. Removing the 45 day requirement was a positive step. But, Congress's total lack of guidance as to the meaning of the now-crucial ordinary course requirements leaves the exception in as confused a state as it was before the amendment. It will take years of litigation before the courts clearly establish the boundaries of the exception. Hopefully, in doing so, they will follow and expand upon the few decisions to date that have examined the ordinary course requirements while providing a consistent and structured framework to guide future decision makers. But, un-

[283] 11 U.S.C. § 547(g).

til this occurs, section 547(c) (2) will continue to evade its stated purpose of "preserving normal financial relations."