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Column
Last in Line

*22 PREFERENCE PRIMER: IS ONCE ENOUGH? IS THE ISOLATED TRANSACTION ORDINARY?

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Editor's Note: *This is the inaugural edition of "Last in Line," a column devoted to issues of particular interest to unsecured creditors in bankruptcy cases. The goal of "Last in Line" is to provide unsecured creditors, and those who represent them, with information and innovative strategies to maximize their recovery in bankruptcy cases. The first column addresses the issue of preferential transfers--a particularly sensitive area for general trade creditors. Future columns will deal with serving on creditors' committees, priorities, reclamation rights, plan strategies and avoidance actions. The column will have three contributing editors: Lisa Sommers Gretchko from Detroit, John D. Penn from Ft. Worth, Texas, and Thomas J. Salerno from Phoenix. As with all columns, the* ABI Journal *welcomes contributions and ideas for articles.*

Explaining preference law to a first-time preference defendant can be very difficult. The client, who is so proud to have collected the debt, gasps at the prospect of giving the money back. Your attempts to explain that preference law is based on "fairness" are futile, because the client has concluded that preference law is a form of Communism that Congress mistakenly overlooked during the McCarthy era! As you explain the ordinary business exception, however, the client instantly calms down, then repeats the words "ordinary business exception" as though they were a mantra. You breathe a sigh of relief.

What do you do, however, when you realize that your client is being sued for payment on an isolated transaction? How do you explain that this otherwise ordinary transaction may, in fact, be ineligible for the ordinary business exception simply because it was the first time that the debtor did business with your client? Courts have been struggling with the issue of whether the isolated transaction is eligible for the ordinary business exception under § 547(c)(2). The cases are split.

Section 547(c)(2) of the Bankruptcy Code prohibits a trustee from avoiding any transfer:

(2) to the extent that such transfer was--
(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms;
Arguably, the isolated transaction runs afoul of §547(c)(2)(B), because the lack of prior dealings between the debtor and the transferee renders it impossible to prove the ordinary course of business between them.

The first reported decision on this issue was *In re Morren Meat and Poultry Company Inc.*, 92 B.R. 737 (W.D. Mich. 1988). Morren purchased meat from ASC Meat Imports only once. The single $41,580.00 invoice required payment within seven days. Morren paid this invoice in two checks of $20,790.00 each. Despite the seven-day payment term, Morren's checks (which ASC received during Morren's preference period) were 31 days and 40 days, respectively, after the invoice date. Morren's bankruptcy trustee sued ASC to recover the $41,580.00, arguing that 11 U.S.C. §547(c)(2) did not apply to an isolated transaction because no ordinary course of business had been established. The trial court granted ASC's motion for summary judgment in an unreported decision, and the district court affirmed in the reported decision cited above.

The district court acknowledged that a prior course of dealing is certainly a factor to consider in determining whether a transaction is ordinary, but rejected the trustee's argument that it was the *sine qua non* of the ordinary business exception. The district court noticed that the operative language of §547(c)(2)(B) reads: "made in the ordinary course of business or financial affairs *of* the debtor and the transferee." Since this statute does not use the word "between," the district court reasoned that §547(c)(2)(B) does not require any prior transactions *between* the debtor and the transferee. 92 B.R. at 740. In the absence of prior dealings between the parties for the court to analyze, the district court analyzed whether there was anything irregular about the payments at issue. The court rejected the trustee's argument that the payments were not ordinary because they were "split" payments on a single invoice. The court also rejected the trustee's argument that the payments were late, and therefore not ordinary, because ASC accepted the late payments without assessing a service charge. Since there were no unusual collection efforts, the district court concluded that the two payments on this single invoice were ordinary, and exempt from preference recovery under §547(c)(2).

In 1990, the 6th Circuit Court of Appeals also held that a first-time transaction was eligible for the ordinary business exception in *In re Finn*, 909 F.2d 903 (6th Cir. 1990), although the issue arose under §547(c)(2)(A) rather than §547(c)(2)(B). Ms. Finn borrowed $3,500.00 from the Taylor Community Credit Union. Her brother, Mr. Burns, cosigned and guaranteed the loan. Sixteen months later, Ms. Finn filed a chapter 7 bankruptcy petition. She had made regular monthly payments on the loan, which effectively reduced Mr. Burns' contingent liability as a guarantor.

Ms. Finn's chapter 7 bankruptcy trustee sued Mr. Burns, seeking to have him pay Ms. Finn's bankruptcy estate an amount equal to one year's worth of her payments to the Taylor Community Credit Union, claiming (under the *Deprizio* doctrine) that Mr. Burns benefitted from those payments in the reduction of his contingent liability as a guarantor.

The bankruptcy court granted the trustee's motion for summary judgment; the district court affirmed. Mr. Burns appealed to the 6th Circuit Court of Appeals on several grounds, including his claim that he should not have to pay Ms. Finn's bankruptcy estate because her payments to the Taylor Community Credit Union were not recoverable preferences because they were ordinary under § 547(c)(2). The bankruptcy trustee responded that Ms. Finn's loan was not incurred in the ordinary course of Ms. Finn's financial affairs because this was the first time that she had taken out such a loan. The Court of Appeals rejected the trustee's argument, and reversed the district court, noting:

A more difficult question is whether a particular loan can be incurred "in the ordinary course of financial affairs" if the ***23** borrower has not taken out a number of such loans, or a number of such loans from the same institution...Obviously every borrower who does something in the ordinary course of her affairs must, at some point, have done it for the first time. We hold that, as a general rule, subject to the individual fact-finding powers of the district court in a specific inquiry, a transaction can be in the ordinary course of financial affairs even if it is the first such transaction undertaken by the customer. This rule holds where the transaction would not be out of the ordinary for a person in the borrower's position.

909 F.2d at 908.

The Court of Appeals also remanded the case to the bankruptcy court with instructions to conduct a factual analysis of Ms. Finn's loan from the Taylor Community Credit Union to determine whether it was incurred in the ordinary course of financial affairs of a consumer in Ms. Finn's position, or in the ordinary course of Ms. Finn's affairs.

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Morren and *Finn* clearly hold that the ordinary business exception under §547(c)(2) can apply to an isolated transaction as long as the transaction is otherwise normal (i.e. no undue collection efforts, no certified, cashiers or NSF checks, no wire transfers, etc.). However, decisions since *Morren* and *Finn* seem to erode the protection that §547(c)(2) might offer to the isolated transaction.

In 1993, the bankruptcy court for the Eastern District of Missouri issued its decision in *In re Keller Tool Corp.*, 151 B.R. 912 (Bankr. E.D. Mo. 1993) which followed *Morren,* but reached the opposite conclusion on virtually identical facts and held that the isolated transaction was not ordinary. The debtor, Keller, did business with CTS Systems only once: it purchased computer hardware and software. On August 7, 1991, CTS Systems delivered an invoice reflecting a $5,070.08 balance due. The invoice had a 30-day payment term. Keller paid this invoice in two checks, one in the amount of $2,500.00; another in the amount of $2,570.08. Despite the 30-day invoice terms, Keller's checks (which CTS received during Keller's preference period) were issued 60 and 62 days, respectively after the invoice date. In short, *Keller* and *Morren* have identical operative facts: (1) The parties had not done business before; (2) there was one invoice that specified a payment due date; (3) the debtor paid the invoice in two payments that were roughly half of the invoice amount; and (4) payments were late--significantly beyond the payment due date specified in the invoice.

Like the court in *Morren,* the *Keller* court noted that the relationship and nature of dealings between Keller and CTS Systems were key considerations in the ordinary business defense, but not exclusive ones. Citing *Morren, Keller* held that in the absence of prior business dealings between the parties, the court may analyze the parties' ordinary course of dealings in other transactions. However, the court noted that it must also examine the transaction at issue. In reviewing the facts of the isolated transaction before it, the *Keller* court swerved away from the *Morren* analysis and accepted the trustee's argument that the payments made 60 and 62 days, respectively, on the 30-day invoice were late, and therefore *not* ordinary.

Although the *Keller* holding is disturbing to the preference recipient, *Keller* generally follows the logic of *Morren,* and reached the opposite ruling from *Morren* because the payments at issue were significantly late. *Keller* did not rule that ***32** isolated transactions are *per se* ineligible for the ordinary business exception.

However, *In re Brown Transport Truckload Inc.*, 152 B.R. 690 (Bankr. N.D. Ga. 1992) ruled that an isolated transaction is *per se* ineligible for the ordinary business exception. Brown made one $18,080.40 payment to Barrett Oil Distributors during its preference period; the payment covered two invoices. Brown's bankruptcy trustee sued to avoid the $18,080.40 payment, then filed a motion for summary judgment claiming that there was no material issue of fact, and that the transfer should be avoided as a matter of law. The trustee argued that the ordinary business exception did not apply to an isolated transfer, because there was no prior course of dealing between the parties; therefore § 547(c)(2)(B) could not be satisfied. Barrett Oil Distributors admitted that there were no material issues of fact, but argued that the $18,080.40 payment was exempt from preference recovery because it was ordinary.

The court carefully analyzed §547(c)(2) and held that Barrett Oil Distributors must prove that the transfer was made in the ordinary course of business *between* the debtor and the transferee. Although *Brown* did not cite *Morren,* it silently rejected the *Morren* approach, and held that it is improper under §547(c)(2)(B) to determine merely whether the transaction was ordinary for the debtor and ordinary for the transferee, because that approach rendered superfluous the "ordinary industry standards" criteria set forth in § 547(c)(2)(C):

> This court agrees with plaintiff and thinks that the better interpretation of the statute is that §547(c)(2)(B) requires a transferee to show that the transfer was made in the ordinary course of business *between those two parties...* (citations omitted). Merely showing that the actions were taken in the ordinary course of the parties' respective ordinary course of business, without showing the prior course of dealing between the parties, is not sufficient. Moreover, such a statutory construction would make §547(c)(2)(C) superfluous, since that subsection requires that the transfer also be made according to ordinary business terms, which is

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> determined by using an objective standard... (citation omitted). Effect must be given to all words employed by Congress.

152 B.R. at 692.

Therefore, the court in *Brown* granted the trustee's motion for summary judgment and held that an isolated transaction is *per se* ineligible for the ordinary business exception.

It is remarkable that courts have reached such diametrically opposite results from an analysis of the language of §547(c)(2). *Morren* focused on the absence of the word "between" in §547(c)(2)(B), then concluded that the isolated transfer is eligible for the ordinary business exception because the statute did not expressly require prior dealings *between* the parties. The *Morren* analysis, however, fails to consider that the word "of" in the context of §547(c)(2)(B) appears to mean "between," especially since any other interpretation of §547(c)(2)(B) is tantamount to analyzing the ordinary business terms, thereby making §547(c)(2)(C) unnecessary.

In terms of strict statutory analysis, the *Brown* conclusion that § 547(c)(2)(B) requires proof of the prior course of dealing *between* the parties makes sense, and gives separate purpose and meaning to §547(c)(2)(C), which requires proof that the transfer was made according to ordinary business terms. Thus, the strength of the *Brown's* statutory analysis is that it accounts for all the statutory language and differentiates the proofs required under § 547(c)(2)(B) from the proofs required under §547(c)(2)(C), thereby giving effect to each statutory prong of the ordinary business exception.

However, in concluding that an isolated, normal transfer is entitled to the protection of the ordinary business exception, *Morren, Finn* and even *Keller* make more sense than *Brown* in the business world. Why should a normal business transaction be ineligible for the ordinary business exception simply because it was the first time that the debtor did business with the transferee? This result is nonsensical. As the court in *Finn* noted, the first-time nature of a transaction should not constitute an irregularity because there must be a first time for everything! *Morren* and *Finn* also promote the legislative intent behind the ordinary business exception which was to:

> leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.

H.R. Rep. No. 95-595, at 373, U.S. Code Cong. & Admin. News 1978, p. 6329.

While *Brown's* holding may be more consistent with rules of statutory construction, it is contrary to the legislative intent behind the ordinary business exception.

Although there are only a handful of reported decisions in this area, it appears that many bankruptcy lawyers have encountered this issue, and there may be numerous unreported decisions. It would be helpful if courts would zealously report all decisions on the issue of whether the ordinary business exception applies to the isolated transfer; this would give practitioners a more well-rounded view of the judicial application of §547(c)(2). However, until § 547(c)(2) is amended to address the regular, normal, first-time transaction, this area promises to remain confusing and frustrating for lawyers and clients alike.

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