17-SEP Am. Bankr. Inst. J. 32

American Bankruptcy Institute Journal
September, 1998

Column
Last in Line

*32 SHARPENING AND POLISHING THE "OBJECTIVE PRONG" OF §547(C)(2)- A CLOSER LOOK AT THE ORDINARY COURSE OF BUSINESS PREFERENCE DEFENSE

Lisa Sommers Gretchko Patrick Casey Coston

Copyright (c) 1998 by the American Bankruptcy Institute; Lisa Sommers Gretchko, Patrick Casey Coston

Section 547 is one of the most well-known and oft-invoked "swords" of the Bankruptcy Code: It enables debtors and trustees to avoid preferential transfers. 11 U.S.C. 547(c)(2) contains one of the well-known and oft-invoked "shields" against preference actions: the ordinary course of business defense. Pursuant to this defense,
(c) The trustee may not avoid under this section a 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.
Despite the notoriety of §547(c)(2), numerous circuit court decisions indicate that there has been considerable confusion surrounding the so called "objective" third prong of the ordinary business defense, namely §547(c)(2)(C). The language of §547(c)(2)(C) is deceptively simple--six easy words--"made according to ordinary business terms." However, the case law demonstrates that the devil is in the details.

Initially, the confusion centered on whether §547(c)(2)(C) required proof of something different than that required by §547(c)(2)(B), *i.e.*, that the transaction was in the ordinary course of business between the parties. The courts were once divided on this issue, and at least one circuit court lumped together subsections (B) and (C) of §547(c)(2) and used a subjective analysis. *See In re Craig Oil*, 785 F.2d 1563, 1565 (11th Cir. 1986). *See, also*, discussion in *In re Tolona Pizza Products*, 3 F.3d 1029, 1031 (7th Cir. 1993).

Loathe to judicially rewrite 11 U.S.C. §547(c)(2), the Seventh Circuit Court attempted to divine the true purpose of §547(c)(2)(C) within the strict confines of the statute as written. In *Tolona Pizza Products*, the court found that §547(c)(2)(C) serves two functions. The first, an evidentiary function, is described as follows:

> If the debtor and creditor dealt on terms that the creditor testifies are normal for them but that are wholly unknown in the industry, this casts some doubt on his (self-serving) testimony.

Tolona at 1032. The second purpose identified in *Tolona* is to allay the "concerns of creditors that one or more of their number may have worked out a special deal with the debtor, before the preference period, designed to put that creditor ahead of the others in the event of bankruptcy." *Tolona* at 1032.

Because the preference defendant must prove *all three* of the prongs of §547(c)(2) by a preponderance of the evidence (*See, e.g.,* *In re Carled Inc.,* 91 F.3d 811 (6th Cir. 1996)), it is important for preference defendants to know *how* to prove the third prong of the ordinary course of business defense. Fortunately for such defendants, case law has evolved to provide some illustrative guidance in this regard. Those courts addressing this issue have concluded that the benchmark for ordinariness under §547(c)(2)(C) is the norm in the *creditor's* industry. *Advo Systems Inc. v. Maxway Corp.,* 37 F.3d 1044, 1048 (4th Cir. 1994). In *In re Sacred Heart Hospital of Norristown,* 200 B.R. 114 (Bankr. E.D. Penn. 1996), the court noted that *no* case suggests that a preference defendant can succeed by confining its evidence on §547(c)(2)(C) to the debtor's industry, and that the cases that mention the issue appear "to *uniformly assume* without expressly addressing the issue that the focus must be on the creditor's entire industry." *Sacred Heart* at 118-119.

Case law also has established that §547(c)(2)(C) requires more than proof of just the preference defendant's relationship with its own customers. *See* *In re Fred Hawes Organization,* 957 F.2d 239, 245-246 (6th Cir. 1992) and *In re Molded Acoustical Products Inc.,* 18 F.3d 217, 221 (3rd Cir. 1994). In *Tolona Pizza,* 3 F.3d 1029, 1033 (7th Cir. 1993), the Seventh Circuit espoused what appears to be the seminal definition of "ordinary business terms," defining it as:

> the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of Subsection C.

Tolona's definition of ordinary business terms has been widely, if not universally, adopted. *See, e.g.,* *In re Molded Acoustical Products Inc.,* 18 F.3d 217, 220 (3rd Cir. 1994); *In re Carled,* 91 F.3d 811, 815-816 (6th Cir. 1996); *In re Thompson Boat Company,* 199 B.R. 908, 915 (Bankr. E.D. Mich. 1996). Applying *Tolona*'s definition, the Sixth Circuit has held that "ordinary business terms" means that "the transaction was not so unusual as to render it an aberration in the relevant industry." *Carled* at 818.

In *In re U.S.A. Inns of Eureka Springs, Arkansas,* 9 F.3d 680 (8th Cir. 1993), the Eighth Circuit held that for purposes of §547(c)(2)(C), it is appropriate to examine the manner in which similarly situated creditors in the industry deal with their delinquent customers, and whether that is the industry norm. More recently, however, two courts have held that for purposes of §547(c)(2)(C), the preference defendant must focus on how the industry treats *healthy,* as opposed to moribund, customers. *In re Molded Acoustical Products Inc.,* 18 F.3d 217, 227 (3rd Cir. 1994) and *In re Thompson Boat Company,* 199 B.R. 908, 916 (Bankr. E.D. Mich. 1996) (which expressly rejected *U.S.A. Inns of Eureka*).

If the preference defendant seeks to prove that the debtor's late payments are within ordinary business terms as defined in (c)(2)(C), the defendant need not show that similar late payments represent a majority of the industry's transactions, or that the tardiness in payment is a pattern for a significant percentage of specific customers. Rather, the preference defendant need only show that it is not aberrational, unusual or idiosyncratic for companies in the defendant's industry to accept payments that ***33** are as late as the late payments at issue in the preference case. *Carled* at 818. Thanks to the nearly universal acceptance of *Tolona*'s definition of "ordinary business terms," which itself adopts a flexible "broad range" approach, preference defendants are spared the "task of proving the existence of some single, uniform set of industry-wide credit terms." *See* *Advo Systems Inc. v. Maxway Corp.,* 37 F.3d 1044, 1048 (4th Cir. 1994). Nevertheless, some specificity is required: A preference defendant cannot satisfy §547(c)(2)(C) by claiming that it was the industry norm to "work with" customers. *See Advo Systems* at 1052.

A review of the proofs in some of the following cases demonstrates which proffers satisfy §547(c)(2)(C) and which are insufficient. In *In re Fred Hawes Organization,* 957 F.2d 239, 245-246 (6th Cir. 1992), the Sixth Circuit Court of Appeals stated in dicta that a defendant's proof of "ordinary business terms" requires *more* than just the testimony of the defendant's president showing how the defendant deals with other customers who pay late. Instead, the Sixth Circuit would require evidence

 © 2016 Thomson Reuters. No claim to original U.S. Government Works.

showing how that "particular transaction comports with the standard conduct of business within the industry." In *In re Molded Acoustical Products Inc.*, 18 F.3d 217, 220 (3rd Cir. 1994) the court held that the testimony of the defendant's president as to the defendant's own collection practices with another delinquent customer failed to establish an industry standard that is required under §547(c)(2)(C).

In *In re Sacred Heart Hospital of Norristown*, 200 B.R. 114, 117 (Bankr. E.D. Penn. 1996), the only evidence proffered under §547(c)(2)(C) was the testimony of the defendant's long-time employee (who was also the director of a trade organization), who testified that the payments at issue were within the range of ordinary business terms with the defendant's hospital customers, but outside the range of typical terms of the defendant's other customers. The court found that this proof did not satisfy the defendant's burden under §547(c)(2)(C) because it focused on what was ordinary in the *debtor's* industry, even though the proper focus is on the *creditor's (i.e.,* the preference defendant's) industry.

In *Thompson Boat Co.*, the preference defendant, Volvo, proffered testimony from its largest competitor, Mercruiser. The defendant's credit manager testified that Mercruiser held close to 90 percent of the market share, and that Volvo held the remaining 10 percent. A representative from Mercruiser testified that the ordinary business terms in the industry were *invoice terms.* With Mercruiser's 90 percent market share, the court found that the testimony from Mercruiser's employee established "ordinary business terms" under §547(c)(2)(C), and that the late payments at issue were therefore not ordinary. *Thompson Boat* demonstrates that while testimony from a competitor may help establish "ordinary business terms" under §547(c)(2)(C), it is important to ensure that the preference payments at issue in fact fall within those terms.

In *In re Carled Inc.*, 911 F.2d 811 (6th Cir. 1996), the defendant offered evidence of its own billing practices, the billing practices of its affiliate and the billing practices of some of its competitors, and testimony regarding how hard it is to determine the billing practices of other competitors. Although the bankruptcy court and the district court held that this evidence was insufficient to satisfy §547(c)(2)(C), the Sixth Circuit reversed, finding that the evidence sufficiently proved that the payment was within industry standards.

In *In re Tennessee Valley Steel Corp.*, 201 B.R. 927 (Bankr. E.D. Tenn. 1996), the issue was whether the five-day grace period after the invoice due date was within ordinary business terms under §547(c)(2)(C). The defendant's general manger testified that 30 percent of the defendant's customers regularly paid within the five-day grace period and were not charged a penalty. The defendant's office manager corroborated this testimony. The defendant also called an expert in the field of public and private utilities and their billing and collection practices: the expert testified that a five-to six-day grace period is standard in the industry and not an aberration. Based on this proof, the court held that the defendant sustained its burden of proof under §547(c)(2)(C).

In *In re Speco Corporation*, 218 B.R. 390 (Bankr. S.D. Ohio 1998), the defendant offered affidavit testimony of its treasurer and vice president of finance in support of its summary judgment motion. The affidavit stated that the late payments at issue were not unusual. The defendant also offered the affidavit of a certified public accountant who stated that, based upon the Robert Morris Associates Annual Statement Studies for the pertinent year, the ordinary range of late payments was 11-43 days and, therefore, the transactions at issue were ordinary. The court held that the defendant sustained its burden of proving §547(c)(2)(C), and granted the defendant's motion for summary judgment on this issue.

Conclusion

While §547(c)(2)(C) may have been a source of confusion in the past, case law has evolved to elucidate the meaning of "ordinary business terms" and the means by which the defendant can satisfy its burden of proof under §547(c)(2)(C). While the devil may still be in the details, the case law has significantly buffed and sharpened the objective prong of the ordinary course of business defense, clarifying what steps the defendant must take in order to combat the preference action. As such, the objective prong now provides a steady beacon by which the defendant can successfully defend the preference action, and thereby avoid falling to last in line.

WESTLAW © 2016 Thomson Reuters. No claim to original U.S. Government Works.

17-SEP AMBKRIJ 32

End of Document

© 2016 Thomson Reuters. No claim to original U.S. Government Works.