

The End of Preference Liability for Unsecured Creditors: New Section 547(c)(2) of the Bankruptcy Code

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INTRODUCTION

Assume that Debtor signed an unsecured note on January 1 obligating himself to pay Creditor \$10,000.00 per month for the next twelve months. Assume also that Debtor made each payment from February through December but then succumbed to financial pressures and filed for bankruptcy on December 31. In these circumstances, prior to July 10, 1984, the trustee-in-bankruptcy had an excellent chance of recovering the \$10,000.00 payments made on December 1, November 1 and October 1 since all of the elements of a preference appear to have been met.¹ The elements of a preference under section 547(b) of the Bankruptcy Code can be summarized as follows:

1. A transfer;²
2. Of "an interest of the debtor in property" of the estate;³
3. "[T]o or for the benefit of a creditor;"⁴

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1. 11 U.S.C.A. § 547(b) (West 1979 & Supp. 1984).

2. *Id.* The Bankruptcy Code defines "transfer" as including "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption . . ." 11 U.S.C. § 101(48) (1982). One court recently noted that the Code's definition is extremely broad. "'Transfer' is defined . . . as including every method of disposing of or parting with an interest in property." *In re Tonyan Constr. Co.*, 28 Bankr. 714, 728 (N.D. Ill. 1983) (emphasis added).

3. 11 U.S.C.A. § 547(b) (West 1979 & Supp. 1984). Prior to the 1984 amendment, § 547(b) was concerned only with a transfer "of property of the debtor." 11 U.S.C. § 547(b) (1982). Although the legislative history does not reveal the reason for including the language "an interest of the debtor in property," Congress may have feared that courts would not look to § 541's broad definition of property in construing § 547 as well as other sections. *See* 11 U.S.C. § 541(a)(1) (1982) (defining property as "all legal or equitable interests of the debtor in property" (emphasis added)).

4. 11 U.S.C.A. § 547(b)(1) (West 1979 & Supp. 1985). Under this requirement, recovery of a fraudulent conveyance to a relative for lack of fair consideration may be available under § 548(2), 11 U.S.C. § 548(2)(a) (1982), but would not qualify as a preference. The conveyance would not be "to or for the benefit of a creditor." 11 U.S.C.A. § 547(b)(1) (West 1979 & Supp. 1985) (emphasis added).

4. On account of an antecedent indebtedness;⁵
5. While debtor was insolvent;⁶
6. "Within 90 days before the date of the filing of the petition;"⁷
7. With the effect of providing the creditor with a greater share of the bankruptcy estate than the creditor would have recovered in a liquidation case if the transfer had not been made.⁸

The above facts do not reveal whether Debtor was insolvent at the time of payment. The trustee, however, is greatly aided under the Bankruptcy Code since Debtor is presumptively insolvent during the 90-day period prior to bankruptcy filing.⁹ Moreover, unless the creditor can establish some sort of priority,¹⁰ it seems obvious that the creditor is better off, having received the payment, than if the payment had not been made. Thus, there is a preferential effect.¹¹

5. 11 U.S.C.A. § 547(b)(2) (West 1979 & Supp. 1985). See, e.g., *Dean v. Davis*, 242 U.S. 438, 443 (1917) (a preference implies paying or securing a pre-existing debt owed to the person preferred). See also *National City Bank v. Hotchkiss*, 231 U.S. 50 (1913). In *Hotchkiss*, the debtor borrowed money at 10:00 A.M. to pay cash for stocks which he intended to pledge, in the ordinary course of business, elsewhere for cash later that same day. The original lender was to be repaid that afternoon with the funds secured by pledging the newly acquired stock. An immediate decline in the market value of the shares ruined the debtor by midday. The debtor advised the original lender that it intended to file a petition in bankruptcy by the end of the day. The lender, in turn, procured stock certificates from the debtor as security for its loan. The certificates were not earmarked or segregated as security for a period of about four hours. The Court noted that "[t]ime sometimes can be disregarded when it is insignificant. But in this case half the time between the loan and the transfer . . . sufficed to change the position of the borrowers from a fortune . . . to a deficit" The Court found the transfer to be preferential. *Id.* at 58.

6. 11 U.S.C.A. § 547(b)(3) (West 1979 & Supp. 1985). The Code defines "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of (i) property transferred, concealed or removed with intent to hinder, delay, or defraud . . . creditors," and exclusive of the entity's exempt property. 11 U.S.C. § 101(29) (1984). The Bankruptcy Code provides a presumption of debtor's insolvency "on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 547(f) (1982). The presumption created by § 547(f) shifts the burden of going forward with evidence of solvency to the adverse party. The burden of proof of the debtor's insolvency remains with the party in whose favor the presumption operates. H.R. REP. NO. 595, 95th Cong., 1st Sess. 375 (1977). See, e.g., *Clay v. Traders Bank*, 708 F.2d 1347 (8th Cir. 1983).

7. 11 U.S.C. § 547(b)(4)(A) (West 1979 & Supp. 1985). The 90-day limit imposed by the Code represents a change from § 60a(1) of the Bankruptcy Act which treated transfers made within four months of the date of filing as preferences. 11 U.S.C. § 95a(1) (1976). In the case of transfers to insiders, defined *infra* at note 37, the trustee may avoid transfers made within a year of bankruptcy filing. 11 U.S.C. § 547(b)(4)(A) (West 1979 & Supp. 1985).

8. 11 U.S.C.A. § 547(b)(5) (West 1979 & Supp. 1985). The transfer of property to a priority creditor does not constitute a preference unless the bankrupt's assets prove insufficient to pay all of the priority class claims. See, e.g., *In re Flick*, 105 F. 503 (S.D. Ohio 1900).

9. See 11 U.S.C. 547(f) (1982), discussed *supra* note 6.

10. See 11 U.S.C.A. § 547(b)(5) (West 1979 & Supp. 1985), discussed *supra* note 8. See generally § 507(a) setting forth a list of priority creditors. 11 U.S.C.A. § 507(a)(1)-(7) (West 1979 & Supp. 1985).

11. 11 U.S.C.A. § 547(b)(1)-(5) (West 1979 & Supp. 1985). E.g., *Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co.* (*In re Sportfame of Ohio, Inc.*), 40 Bankr. 47, 55 (Bankr. N.D. Ohio 1984).

Until recently it was generally conceded that there was no section 547(c) defense to preference liability under the above facts.¹² Section 547(c)(2) of the Bankruptcy Reform Act of 1978 did provide creditors with a defense

(2) to the extent that such transfer was—

- (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
- (B) made not later than 45 days after such debt was incurred;
- (C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
- (D) made according to ordinary business terms.¹³

However, even if the debt was incurred and made in the ordinary course of business and was paid according to ordinary business terms, most courts would have held that the debt described above was incurred on January 1.¹⁴ Thus, the payment was not made within 45 days after such debt was incurred, and there could be no section 547(c)(2) defense.

On July 10, 1984, Congress amended section 547(c)(2) to remove the 45-day limitation. Section 547(c)(2) now provides creditors with a defense

(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.¹⁵

The amended statute provides Creditor in the above example with a defense to preference liability.¹⁶

It is not clear, however, what Congress intended concerning other cases where there is potential preference liability. For example, it was generally held prior to the recent amendment that credit card customers "incur" a debt within the meaning of section 547(c)(2) at the time of the charge.¹⁷

12. See *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981), discussed *infra* at text accompanying notes 47-60 and authorities cited *infra* at notes 59-60.

13. 11 U.S.C. 547(c)(2) (1982).

14. See *infra* notes 47-60 and accompanying text.

15. 11 U.S.C.A. 547(c)(2) (West 1979 & Supp. 1985).

16. See 130 CONG. REC. S8897 (daily ed. June 29, 1984) (statements of Sen. DeConcini and Sen. Dole), discussed *infra* at text accompanying notes 65-66.

17. See, e.g., *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981), discussed *infra* at text accompanying notes 47-60. See also *In re Brown*, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982). During the 90 days preceding the debtor's filing of his petition in *Brown*, the defendant credit card company made three billings and received payments totalling \$6,664.36. *Id.* at 555. The defendant argued that since it did not expect payment until after a monthly bill was issued, the debt was not incurred until after the bill was in fact sent to the debtor. *Id.* at 556. In analyzing the defendant's argument, the court noted that

[t]he debtor's obligation to the defendant . . . arises out of a series of unconnected transactions with various independent suppliers of goods and services. . . . When the debtor elected to charge the item as a credit transaction, a credit card was employed. . . . At this point a credit obligation "was incurred." Credit was extended and a debt was created.

Id.

Thus, the 45-day period began to run from the time the goods were purchased, not from the time the cardholder received a statement from the credit card company. Although that issue is now resolved,¹⁸ new section 547(c)(2) does not appear to place *any* limitation on the length of time that the debtor has to repay the debt. As long as the debt is incurred according to "ordinary business terms" and paid in the "ordinary course of business," there is a section 547(c)(2) defense.¹⁹ Thus, in the original example, if the entire balance of the note was due on July 1 but was not paid until December 1, there may be a defense under section 547(c)(2). It is not clear, however, that this result was what Congress intended.

New section 547(c)(2) may also render section 547(c)(4)²⁰ superfluous while substantially undermining the scope of sections 547(c)(1)²¹ and 547(c)(5).²² Section 547(c)(1) provides a defense for transactions that were intended to be contemporaneous exchanges but technically were not.²³ Section 547(c)(4) provides a credit against preference liability to those transferees who give the debtor "new value" after receiving a preferential transfer.²⁴ As demonstrated below,²⁵ most of the payments made in the course of transactions that could be given complete protection under section 547(c)(1) and partial protection under section 547(c)(4) are incurred and made in "ordinary course of business" and are paid "according to ordinary business terms." Thus, a defense may exist under amended section 547(c)(2). Section 547(c)(5) provides a defense for inventory and accounts receivables lenders.²⁶ Because payments to such lenders usually will meet subsection (c)(2) payment criteria, it again appears that a defense is available.

This article examines the legislative history behind original section 547(c)(2) and then examines the meager legislative history behind the recent amendment. The article also describes the potentially devastating effect the amendment will have on the trustee's ability to avoid preferential transfers. Finally, the article analyzes several arguments that bankruptcy trustees are likely to advance for giving section 547(c)(2) a limited construction.

I. THE HISTORY OF 1978 SECTION 547(C)(2)

The rationale for including a section 547(c)(2) defense appears to be in response to Congress' 1978 decision to ease the trustee's burden in estab-

18. See, e.g., *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981); *In re Brown*, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982), and *supra* text accompanying note 17.

19. 11 U.S.C.A. § 547(c)(2) (West 1979 & Supp. 1985).

20. 11 U.S.C. § 547(c)(4) (1982). See *infra* text accompanying note 81 for the complete text of the subsection.

21. 11 U.S.C. § 547(c)(1) (1982). See *infra* text accompanying note 77 for the complete text of the subsection.

22. 11 U.S.C.A. § 547(c)(5) (West 1979 & Supp. 1985). See *infra* note 90 for the complete text of the subsection.

23. See *infra* notes 76-80 and accompanying text.

24. See *infra* notes 81-86 and accompanying text.

25. See *infra* text accompanying notes 77-81.

26. See *infra* notes 88-92 and accompanying text.

lishing a preference. Prior to 1978, it was necessary for the trustee to prove that, at the time of transfer, the debtor was "insolvent"²⁷ and the transferee had "reasonable cause to believe that the debtor [was] insolvent."²⁸ While the "reasonable cause to believe" requirement was not an element of a preference, the trustee needed to prove its existence in order to void the transaction.²⁹ The trustee's job of proving insolvency was virtually impossible since many debtors' records were in disarray.³⁰ In any event, both requirements were difficult to establish. In 1978, Congress dealt with the insolvency problem by creating a "presumption"³¹ of insolvency which required the transferee to come forward with some evidence of solvency in order to shift the burden of proof to the trustee.³²

Application of the "reasonable cause" requirement also proved to be less than satisfactory. Some commentators questioned whether a preferred transferee should enjoy the benefits of the preference even where the transferee had no knowledge about the debtor's financial affairs.³³ Arguably, Congress should decide through the priority section which claims are paid and which ones are not. Further, the debtor should not be permitted to defeat this legislative policy simply by making preferential payments on the eve of bankruptcy. Moreover, many transferees may have known about the debtor's financial condition but, because of their familiarity with bankruptcy law, were not willing to admit such knowledge. In cases where there was evidence that the transferee was aware of the debtor's financial condition, there seemed to be no consistency as to when "reasonable cause to believe insolvency" existed. Many courts required transferees who had some knowledge of fi-

27. 11 U.S.C. § 96(a)(1) (1976). Under the Bankruptcy Act a person [was] deemed insolvent . . . whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at fair valuation be sufficient in any amount to pay his debts.

11 U.S.C. § 1(19) (1975).

28. 11 U.S.C. § 96(b) (1975).

29. The factors which caused a transfer to be regarded as a preference were set forth in § 60a of the Bankruptcy Act. 11 U.S.C. § 96(a) (1976). The preference was, in turn, regarded as voidable only if the requirements of § 60b were met. 11 U.S.C. § 96(b) (1975). Section 60b required the trustee to prove that the transferee had a "reasonable cause to believe" that the debtor was insolvent.

30. *See, e.g., Dinkelspiel v. Weaver*, 116 F. Supp. 455 (W.D. Ark. 1953). The district court in *Dinkelspiel* ruled that evidence consisting of a balance sheet and a profit and loss statement based upon assumptions and uncertainties and concerning the non-payment of the debtor's checks and notes was insufficient to find insolvency at the time of the transfer. *Id.* at 459.

31. 11 U.S.C. § 547(f) (1982).

32. *See S. REP. NO. 989, 95th Cong., 2d Sess. 87 (1978)*. *See supra* note 6 and accompanying text. *See also Campbell v. Cannington (In re Economy Milling Co.)*, 37 Bankr. 914 (Bankr. D.S.C. 1983) (upholding the validity of § 547(f) against the challenge that it violates due process in part on the basis that § 547(f) merely requires the creditor to come forward with *some* evidence of solvency).

33. *See, e.g., Morris, Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 738-40 (1970).

nancial problems of the debtor to inquire further into the debtor's financial affairs.³⁴ They then charged the transferee with knowledge of those facts that an inquiry would have revealed.³⁵ The "reasonable cause" requirement evolved into something that the trustee had to establish without the benefit of any standards.

The Bankruptcy Commission³⁶ proposed that the reasonable cause re-

34. See, e.g., *Hoppe v. Rittenhouse*, 279 F.2d 3 (9th Cir. 1960) (reasonable cause to believe a debtor insolvent depends on whether the facts known to the creditor and any additional facts the creditor may be charged with would produce such a belief in a reasonably prudent business person); *Boston Nat'l Bank v. Early*, 17 F.2d 691 (1st Cir. 1927) (the test for whether a creditor had reasonable cause to believe a debtor was insolvent is whether facts were such as to put the creditor on inquiry, which would have disclosed the debtor's insolvency); *Miller v. Wells Fargo Bank Int'l Corp.*, 406 F. Supp. 452 (D.C.N.Y.) (a creditor may not preserve his ignorance of the debtor's financial condition), *aff'd*, 540 F.2d 548 (2d Cir. 1979); *Stein v. Rand Constr. Co.*, 400 F. Supp. 944 (D.C.N.Y. 1974) (a creditor's inquiry as to a debtor's financial state, directed only to the debtor, is insufficient to prove that the creditor lacked reasonable cause to believe in the debtor's insolvency where the circumstances are such that an ordinary prudent person would make further inquiries).

35. See, e.g., *Miller v. Wells Fargo Bank Int'l Corp.*, 406 F. Supp. 452 (D.C.N.Y.), *aff'd*, 540 F.2d 548 (2d Cir. 1979); *Mack v. Bank of Lansing*, 396 F. Supp. 935 (W.D. Mich. 1975) (facts which are sufficient to incite an ordinary reasonable person to make inquiry into the debtor's solvency charge the creditor with all knowledge he could have gained from such inquiry); *Stein v. Rand Constr. Co.*, 400 F. Supp. 944 (D.C.N.Y. 1974) (a creditor cannot deliberately maintain his ignorance of the debtor's financial condition; the creditor is chargeable with all of the facts which reasonably prudent inquiry into the debtor's solvency would reveal).

36. The Commission on the Bankruptcy Law of the United States was established by Public Law 91-354 on July 24, 1970. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468, 468-69 (1970). The Commission was formed to study, analyze, evaluate and recommend changes both in the substance and administration of bankruptcy.

Public Law 91-354 created a Commission consisting of nine members. Those members were Harold Marsh—Chairman, Wilson Newman, Charles Seglison, Senator Quentin Burdick, Senator Marlow Cook, Representative Don Edwards, Representative Charles Wiggins, Judge Edward Weinfeld and Judge Hurbert Wills. The Commission staff consisted of an executive director, a deputy director, a research specialist and an administrative officer. Frank R. Kennedy, a prominent professor from the University of Michigan Law School and a reporter for the Rules Committee of the Judicial Committee, was appointed as Executive Director.

Public Law 91-354, as enacted, provided for a two-year life for the Commission. The Commission did not formally commence its operations until June, 1971, nearly 11 months after its originally allotted time. Therefore, Congress extended the life of the Commission by Public Law 93-56 through August, 1973. Act of July 1, 1973, Pub. L. No. 93-56, 87 Stat. 140 (1973). After conducting four public hearings and 44 days of Commission deliberation, a two-part report was submitted to Congress on July 31, 1973. REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973). Part I consisted of an evaluation of bankruptcy administration with recommendations for change. Part II embodied a proposed bankruptcy statute with explanatory notes. The Commission's statutory proposal was introduced as a bill in the House of Representatives in 1973. H.R. 10792, 93d Cong., 1st Sess. (1973). A comparable bill was introduced in the Senate at that time. S. 4046, 93d Cong., 2d Sess. (1974). In 1974, a competing bill, proposed by the National Conference of Bankruptcy Judges was also introduced into the House. H.R. 16643, 93d Cong., 2d Sess. (1974). Scant legislative action was taken during the 93d Congress with respect to the proposed bankruptcy bills. However, an intense study of the proposed bankruptcy legislation occurred during the 94th Congress. The Commission's proposal was reintroduced during that session. H.R. 31, 94th Cong., 1st Sess. (1975). The competing bill by the bankruptcy judges was also reintroduced. H.R. 32, 94th Cong., 1st Sess. (1975). In the Senate, the Commission's bill was resubmitted, S. 236, 94th Cong., 1st Sess. (1975), as was the bankruptcy judges' proposal. S. 235, 94th Cong., 1st Sess. (1975). For further discussion on the history of the Commission,

quirement be eliminated for non-insider³⁷ cases.³⁸ This position eventually became law in 1978.³⁹ Moreover, on July 10, 1984, the requirement was dropped even for insider cases.⁴⁰

The Commission, however, did not gauge the concern that the dropping of this test would cause trade creditors. Total abandonment of the "reasonable cause" requirement would have converted virtually any payment to trade creditors during the statutory period of presumed insolvency into a preference. For example, in cases where an insolvent debtor pays his supplier at the end of the month in the usual course of business, the creditor likely would have no knowledge of the debtor's insolvency. Prior to 1978, the payments could not have been recaptured. If, however, the "reasonable cause" requirement were dropped, then the trustee could recover such payments.

Additionally, in pre-1978 cases, where the debtor received an unsecured loan to be repaid in installments, the trustee could not avoid the transfers. If the debtor was current in his payments, then the creditor most likely would not have had reasonable cause to believe that the debtor was insolvent. Thus, those payments could not have been recaptured before 1978 even though they were made within the statutory period.

The National Bankruptcy Conference was the first to recognize the vulnerable position that the proposed abolition of the "reasonable cause to believe insolvency" would have created for utility companies.⁴¹ In 1977, H.R.

see Klee, *Legislative History of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 275, 276-79 (1980).

37. An insider, as defined in the Bankruptcy Code, generally includes the debtor's relatives and those people associated closely with him in a business enterprise. 11 U.S.C. § 101(25) (1982). Prior to elimination of the reasonable cause requirement, when a transfer involved an insider, the Code allowed the trustee to avoid a transfer made within one year of the filing petition in bankruptcy, but only if the trustee could prove the transferee "had reasonable cause to believe the debtor was insolvent at the time of such transfer . . ." 11 U.S.C. § 547(b)(4)(B) (1982).

38. Also, the Commission does not believe that the requirement that there be a certain state of mind on the part of the favored creditor has any rational connection with the objective of this provision, i.e., to achieve a more equitable distribution among all of the creditors. The complete irrationality of the present requirement is demonstrated by the fact that if a debtor turned all of his property into cash and wrote a check to his brother, who was one of his creditors but who lived abroad and had paid no attention whatever to the condition of the business, this payment would not be a voidable preference even if effected the day before the filing of a petition in bankruptcy. Since we have assumed that the brother knew nothing whatever about the debtor's financial affairs, it is obvious that he would not have had reasonable cause to believe that the debtor was insolvent. Yet this fact has no bearing on the injustice to the other creditors. The Commission recommends that this requirement for a voidable preference be eliminated.

COMMUNICATION FROM THE EXECUTIVE DIRECTOR, COMMISSION ON THE BANKRUPTCY LAWS, TRANSMITTING A REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS, H.R. DOC. NO. 137, PART I, 93d Cong., 1st Sess. 19-20 (1973).

39. 11 U.S.C. § 547(b) (1982).

40. 11 U.S.C.A. § 547(b) (West 1979 & Supp. 1985).

41. The Conference proposed that a "debt for utilities incurred within three months of the petition" be excepted from liability. HEARINGS ON H.R. 31; AND H.R. 32 HOUSE JUDICIARY COMMITTEE, 94th Cong., 2d Sess. 1849 (1976).

6⁴² was introduced which proposed new section 547(c)(2). Although the legislative history is sparse,⁴³ the inference is inescapable that objections from trade creditors were intense. As proposed, H.R. 6 provided trade creditors with a defense for payments made in the "ordinary course of business."⁴⁴ Language protecting payments made "in ordinary course of . . . or *financial affairs* of the debtor" was added later.⁴⁵ Because the initial bill emphasized only the "business" aspect of the transaction,⁴⁶ it is probable that the trade creditors were the first to object. Only later was it proposed that payments made by consumer debtors in the ordinary course of their "financial affairs" be protected.

II. APPLICATION OF 1978 SECTION 547(C)(2): THE RULE OF *BARASH* v. *PUBLIC FINANCE CORP.*

One of the earliest constructions of 1978 section 547(c)(2) was provided by the Seventh Circuit in *Barash v. Public Finance Corp.*⁴⁷ In *Barash*, the trustee attempted to recapture payments made during the 90-day preference period in eight separate cases. In each case the creditor was undersecured. The court decided two questions: first, whether elements of a preference existed, and second, and more importantly, whether a defense existed under section 547(c)(2).

As to the first question, the principal issue was whether payments to a partially secured creditor were preferential. The creditors argued that there

42. H.R. 6, 95th Cong., 1st Sess. (1977).

43. An intensive search of the relevant legislative history from the issuing of the Commission Report to the introduction of H.R. 6 does not reveal any statements, other than that of the Bankruptcy Conference, setting forth a need for a section like § 547(c)(2).

44. H.R. 6, 95th Cong., 1st Sess. § 547(c)(2) (1977) read as follows:

- (c) The trustee may not avoid a transfer under this section—
 - (2) to the extent that such transfer was—
 - (A) in payment of a debt incurred in the ordinary course of business of the debtor and the transferee;
 - (B) made not later than 45 days after such debt was incurred;
 - (C) made in the ordinary course of business of the debtor and the transferee; and
 - (D) made according to ordinary business terms.

45. The inclusion of the "financial affairs" language was first proposed in a bill introduced in the Senate. S. 2266, 95th Cong., 1st Sess. § 547(c)(2) (1977). The bill provided:

- (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 in the ordinary course of business or *financial affairs* of the debtor and transferee;
 - (B) made not later than 45 days after such debt was incurred;
 - (C) made in the ordinary course of business or *financial affairs* of the debtor and the transferee; and
 - (D) made according to ordinary business terms.

Id. (emphasis added). See also S. REP. No. 989, 95th Cong., 2d Sess. 88 (1978).

46. See *supra* note 44.

47. 658 F.2d 504 (7th Cir. 1981).

were no preferential payments because they were secured.⁴⁸ The court looked, however, to section 506(a).⁴⁹ That section gave the creditors two claims, one secured and another unsecured. The unsecured claim was determined by the extent to which the claim exceeded the value of the security. Since the payments were being applied to the unsecured portion of the creditors' claim, the court found that they met all section 547(b) requirements and were therefore preferential.⁵⁰

As to the second and main point, the court ruled that there could be no section 547(c)(2) defense. The court conceded that all of the elements of the defense were present except the requirement that the payment be made "not later than 45 days after [the] debt was incurred."⁵¹ In all eight cases, the debts were incurred and paid in the ordinary course of business or financial affairs of the debtor. In addition, they were paid according to ordinary business terms. The court, however, ruled that each debt was incurred at the time that the notes were originally signed, *not* at the time when the installment payment was due. Thus, each payment occurred more than 45 days after the debt was incurred.

In so deciding, the court rejected arguments advanced by Professor Henson who advocated that the section should be construed so that the 45-day period began to run at the time that the installment was due.⁵² Rather, the court accepted the analysis set forth in *Collier on Bankruptcy*,⁵³ and by Mr. Levin,⁵⁴ a member of the House Staff at the time the legislation was drafted. That analysis suggested that the time period should begin to run from the date that the debtors received their loans. *Collier* stated that in utility cases the period started from the time that the "resource was consumed."⁵⁵ Levin indicated that the 45-day period was chosen because 45 days was within a

48. A payment to a secured creditor is not preferential because one of the elements of a preference, namely, that the creditor has not improved his position with respect to other creditors, is not met.

49. 11 U.S.C. § 506(a) (1982) provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

See, e.g., *In re Klein*, 10 Bankr. 657 (Bankr. E.D.N.Y. 1981); *In re Jones*, 5 Bankr. 736 (Bankr. E.D. Va. 1980) (holding that the partially secured creditor's claim should be divided into a secured and unsecured claim). See generally H.R. REP. No. 595, 95th Cong. 1st Sess. 356 (1977).

50. *Barash*, 658 F.2d at 507-09.

51. *Id.* at 509.

52. Henson, *The Uniform Commercial Code and the New Bankruptcy Act: Some Problem Areas*, 35 BUS. LAW. 83, 96 (1979).

53. See 4 COLLIER ON BANKRUPTCY § 547.38 (15th ed. 1980).

54. See Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173 (1979).

55. 4 COLLIER ON BANKRUPTCY § 547.38 (15th ed. 1980).

normal billing cycle for trade creditors.⁵⁶ Thus, the court reasoned that Congress had no intention of protecting those payments made pursuant to an unsecured installment note where payments were made 45 or more days after the loan. The court acknowledged that the payments did not result from unusual action by either the debtors or creditors and, thus, the creditors complained that they "had no way of knowing that the debtors were having financial difficulties."⁵⁷ The court responded:

The short answer to this argument is that the creditor's knowledge or state of mind is no longer relevant. Under the predecessor to § 547 . . . the Trustee had to establish that the creditor had "reasonable cause to believe" that a debtor was insolvent before a transfer could be avoided. Congress eliminated this requirement in favor of the objective criteria under the new Code.⁵⁸

Virtually all cases following *Barash* have embraced its reasoning.⁵⁹

It may be surmised that most trade creditors disagree with the Seventh Circuit's analysis. It certainly would have been advantageous to those creditors if they could have had the additional time that would have been provided if the 45-day period began to run from the date that a bill was sent. The court ruled, however, that the 45-day period began from the time that the product was purchased or the resource was consumed. For example, if a product was purchased on the 15th of the month, but the bill was not sent until the 30th, then under *Barash*, the 45-day period began running on the 15th.⁶⁰

56. See Levin, *supra* note 54, at 186. The language of the jointly issued House and Senate reports tends to reinforce this view:

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. If the debt on account of which the transfer was made was incurred in the ordinary course of both the debtor and the transferee, if the transfer was made not later than 45 days after the debt was incurred, if the transfer itself was made in the ordinary course of both the debtor and the transferee, according to ordinary business terms, then the transfer is protected. The purpose of this exception is 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. 595, 95th Cong., 1st Sess. 373-74 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 88 (1978).

57. *Barash*, 658 F.2d at 510.

58. *Id.*

59. See, e.g., *Sandoz v. Fred Wilson Drilling Co. (Matter of Emerald Oil Co.)*, 695 F.2d 833 (5th Cir. 1983); *Ford Motor Credit Co. v. Ken Gardner Ford Sales, Inc. (In re Ken Gardner Ford Sales, Inc.)*, 23 Bankr. 743 (Bankr. E.D. Tenn. 1982); *Iowa Premium Serv. Co. v. First Nat'l Bank (In re Iowa Premium Serv. Co.)*, 695 F.2d 1109 (8th Cir. 1982). The court in *Iowa* did follow the generally accepted principle that interest payments were not recoverable by the trustee because interest was deemed to be incurred daily.

60. *Rovzar v. Prime Leather Finishes (In re Saco Local Dev. Corp.)*, 30 Bankr. 859 (Bankr. D. Me. 1983); *Keydata Corp. v. Boston Edison Co. (In re Keydata Corp.)*, 37 Bankr. 324 (Bankr. D. Mass. 1983); *Eckles v. Pan Am. Mktg. (In re Balducci Oil Co.)*, 33 Bankr. 843 (Bankr. D. Colo. 1983).

Furthermore, while trade creditors may have been displeased, unsecured lenders must have been in an outright state of anguish. All payments made beyond the 45-day period on unsecured or partially secured notes were preferential if made within 90 days of bankruptcy. This was true even if the payments were regular under the terms of the note and if the creditor was completely unaware of the debtor's financial difficulties.

III. 1984 SECTION 547(c)(2)

As noted above,⁶¹ new section 547(c)(2) changes the old provision by eliminating the 45-day requirement. One additional amendment apparently was made for purposes of clarity. It requires that the debt now must be incurred "by the debtor."⁶² Thus, there is no defense to the trustee's preference claim if the debt was not initially incurred "by the debtor." If someone other than the debtor incurred the debt, an "insider"⁶³ for instance, then any payments made by the debtor on that debt will not be protected by section 547(c)(2) from an attack by the trustee.

The available legislative history reveals that Congress intended to eliminate the 45-day provision, thereby overruling *Barash*, but intended to leave the section otherwise unchanged. The Senate Report reads:

This section eliminates the 45 day limitation contained in section 547 (c)(2). The limitation places undue burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days.⁶⁴

However, the most revealing portion of the legislative history, an important exchange between Senators Dole and DeConcini, indicates that payments on unsecured debt are intended to fall within the new section 547(c)(2) defense:

Mr. DeCONCINI. I know that the Senator from Kansas, along with the Senator from South Carolina,⁶⁵ was the principal sponsor of this provision deleting subsection (c)(2) of section 547 of the code, and I would like to clarify two points 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. That is correct, assuming that the "ordinary course of business or financial affairs" and "ordinary business terms" requirements are met.

61. See *supra* text accompanying note 15.

62. *Id.*

63. See *supra* note 37 for the definition of an "insider." It would be somewhat unusual for a debtor to pay the debt of another. Perhaps it is most likely to occur in cases where the debt paid was incurred by someone closely connected with the debtor. The Code's definition of an "insider" covers most entities closely connected with the debtor.

64. S. REP. No. 65, 98th Cong., 1st Sess. 60 (1983).

65. Referring to Senator Strom Thurmond, Republican, South Carolina.

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 be acting in their respective "ordinary course of business or financial affairs" if they were to deal directly or indirectly with each other in 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 market is an established market, and the participants in it would presumably be acting in ordinary course of their business or financial affairs and on the basis of ordinary business terms.⁶⁶

Unfortunately, of the legislative history which does exist, only the Senate Report and this exchange are of any real value in an attempt to uncover and to understand the legislative intent. Although there is evidence in prior hearings and proposals to amend section 547(c)(2), that protection for obligations such as irrevocable⁶⁷ letters of credit was being considered, the important and persuasive history remains the dialogue between Senators Dole and DeConcini which occurred prior to adoption of the amended section 547(c)(2).⁶⁸ Although the historical gaps are troublesome, one is able to ascertain some things about the scope and limitations of the new provision. Certainly, the limitations that existed prior to 1984, other than the 45-day period, still apply. Thus, debts must be incurred and paid by the debtor according to the "ordinary business or financial affairs of the debtor" and must be paid "according to ordinary business terms."⁶⁹ Neither the 1978 Act itself nor its legislative history further defines or refines "ordinary course of business or financial affairs" or "ordinary business terms." Some of the pre-amendment history suggests that atypical or unusual transactions were not to be covered.⁷⁰ Reference to analogous issues governed by the Uniform Commercial Code is also helpful.⁷¹ While one could speculate about whether,

66. 130 CONG. REC. S8897 (daily ed. June 29, 1984).

67. S. 3023, 96th Cong. 2d Sess. (1980); *Preference Section of the Bankruptcy Code: Hearings Before Subcomm. on Judicial Machinery of the Senate Judiciary Comm. on S. 3023*, 96th Cong. 2d Sess. (Aug. 18, 1980). Professor Vern Countryman, in his forthcoming article in *Vanderbilt Law Review*, gives a complete and detailed history of amended § 547(c)(2), but it provides no greater insights than those alluded to here. The references to buying of commercial paper clearly show that Congress was focusing upon this rather narrow area and had not fully contemplated the scope of the amendment.

68. See *supra* note 66.

69. 11 U.S.C.A. § 547(c)(2) (West 1979 & Supp. 1985).

70. "The purpose of this exception is 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. 595, 95th Cong., 1st Sess. 373-74 (1977) (emphasis added).

71. For example, UCC 2-403 and 9-307(1) give protection, under stated conditions, to "buyers in ordinary course of business" (emphasis added). Section 1-201(9) defines "buyer in ordinary course of business" as, among other things, buying "in ordinary course" of business. Case law interpretation of the section, however, focuses on the nature of the *purchase*, which is of little help in analyzing questions about *incurring* and *paying* debts. See, e.g., *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 612 F.2d 745 (3rd Cir. 1979) (bulk sale does not qualify as sale in "ordinary course" of business); *Rhode Island Hospital Trust Co. v. Leo's Used Car Exch.*, 314 F. Supp. 254 (D. Mass. 1970) (purchase of cars at a place other than the seller's usual place of business was not a sale in ordinary course of business); *National Shawmut Bank v. Vera*, 352 Mass. 11, 223 N.E.2d 515 (1967) (purchase at a judicial sale not a purchase in ordinary course of business).

for example, a debtor's vacation charges are in the "ordinary course of his financial affairs," it is revealing that the courts have rarely struck down a section 547(c)(2) defense on the basis that the payments were not made in ordinary course of business or according to ordinary business terms.⁷²

Given the exchange between Senators Dole and DeConcini, it seems clear that timely payments made on an unsecured note are now within the defense. In addition, since payments to trade creditors were always covered, those payments should continue to be protected.

One can also comfortably assert that this section is not intended to provide a defense to creditors taking security which would otherwise be preferential. The reasons for this are threefold. First, subsection (c)(2) is limited to "payment" of debt. One cannot plausibly argue that the giving of security constitutes "payment" because the security is given to assure payment but does not constitute it. Rarely does the secured creditor at the time of the transaction believe he is buying the debtor's collateral.⁷³ Second, the drafters of the Bankruptcy Code followed the prior law and erected rather elaborate mechanisms which would be rendered superfluous if new section 547(c)(2) applied to security interests.⁷⁴ Finally, most courts have not applied other

72. See, e.g., *Gennet v. Coastal Wholesale, Inc. (In re Martin County Custom Pools Inc.)*, 37 Bankr. 52 (Bankr. S.D. 1984); *Economy Milling Co. v. Campbell (In re Economy)*, 37 Bankr. 914 (Bankr. D.S.C. 1983); *Tinnell Traffic Servs. v. Bradford-White Corp. (In re Tinnell Traffic Services Inc.)*, 41 Bankr. 1018 (Bankr. M.D. Tenn. 1984); *Craig Oil Co. v. Marathon Oil Co. (Matter of Craig Oil Co.)*, 31 Bankr. 402 (Bankr. M.D. Ga. 1983). See generally Duncan, *Loan Payment to Secured Creditors as Preferences Under the 1984 Bankruptcy Amendment*, 64 NEB. L. REV. 83, 89 n.26 (1984).

Generally, courts do not distinguish between transactions made in the ordinary course of business and those made according to ordinary business terms. One court, however, appeared to make this distinction. It expressly held that purchases made by letters of credit were in the ordinary course of business when such letters are issued according to ordinary business terms. *In re Hard Ski Mfg. Co.*, 7 Bankr. 465, 469 (1980). The court defined ordinary business terms according to the "ordinary method" of transacting the particular business at issue. *Id.*

73. See *Gennet v. Coastal Wholesale, Inc. (In re Martin County Custom Pools Inc.)*, 37 Bankr. 52 (Bankr. S.D. Fla. 1984) (holding that when debtor-buyer permitted the creditor-seller to take back items of inventory that no "payment" had occurred within the meaning of the section).

74. See generally 11 U.S.C.A. § 547(e)(1), (2) (West 1979 & Supp. 1985). Section 547(e)(2)(A) provides that the date of transfer shall be the time the "transfer takes effect between the transferor and transferee, if such transfer is perfected at, or within 10 days after such time." In cases involving real property, "perfection" is defined as that point in time "when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(A) (1982). In the case of fixtures and personal property, perfection is defined as that point in time "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(B) (1978). In general, if perfection occurs beyond the 10-day period, the day of transfer becomes the date of perfection. 11 U.S.C. § 547(e)(2)(B) (1982) (providing that the date of transfer shall be "at the time such transfer is perfected, if such transfer is perfected after such 10 days."); e.g., *In re Kelley*, 3 Bankr. 651 (Bankr. E.D. Tenn. 1980) (holding a security interest in an automobile voidable under § 547 because the lien was noted on the certificate of title beyond the 10-day period).

In addition to the elaborate rules defining "transfer," subsection (c) sets forth two separate defenses for secured transaction cases. Section 547(c)(3) creates a defense for purchase money

subsection (c) defenses to secured transactions cases.⁷⁵

With this much established, however, even a slightly expansive reading of new section 547(c)(2) may have the practical effect of eliminating preference liability for almost all payments to unsecured creditors within the 45-day period. Assuming that most preference transactions are business-related, it will be indeed rare that a court could not conclude that a section 547(c)(2) defense is available. Certainly the typical business or consumer loan is incurred in the "ordinary course of business or financial affairs of the debtor." The debtor will usually go to a bank, sign the necessary documents, and borrow the money. Repayment of such debts invariably will be in furtherance of the debtor's business or financial affairs. Finally, the mode of payment, either by check or cash, will be considered as being within "ordinary business terms." There will be a rare case where a debtor incurs and pays a gambling debt (a debt not incurred within the ordinary course or financial affairs of the debtor, unless, of course, he is a professional gambler) or pays a debt by barter (and therefore will not have paid according to "ordinary business terms"). But, in the usual case it will be difficult to find a case in which a preferential payment would *not* fall within the language of the section as commonly understood.

There are good reasons for believing that Congress did not intend to totally emasculate the preference section, or, in fact, that Congress did not even consider general preference law when amending subsection (c)(2). The most compelling is the effect of the suggested construction of subsection (c)(2) upon the remaining subsection (c) defenses. For example, subsection 547(c)(1) was not amended in 1984. That section provides that a defense shall exist:

security interests that are "perfected on or before 10 days after the debtor receives possession" of the collateral. 11 U.S.C.A. § 547(c)(3) (West 1979 & Supp. 1985). Section 547(c)(5) validates the so-called floating lien on inventory and receivables provided that the secured party has not improved his position within the 90-day period prior to bankruptcy "to the prejudice of other creditors holding unsecured claims" 11 U.S.C.A. § 547(c)(5) (West 1979 & Supp. 1985).

It simply is highly unlikely that, in enacting § 547(c)(2), Congress intended to render those provisions governing secured transactions meaningless. If § 547(c)(2) does apply, then creditors could conceivably take security interests within any reasonable time after the loan and be protected. The 10-day provisions set out in § 547(e)(1), (e)(2) and (e)(3) would be superfluous.

75. Several courts have held that subsection (c)(1), *see infra* discussion at text accompanying notes 76-79, does not apply to secured transactions. *See, e.g.,* Gower v. Ford Motor Credit Co. (*In re Davis*), 734 F.2d 604 (11th Cir.), *cert. denied*, 104 S. Ct. 1294 (1984); Ray v. Security Mut. Fin. Corp. (*In re Arnett*), 731 F.2d 358 (6th Cir. 1984); *In re Enlow*, 20 Bankr. 480 (Bankr. S.D. Ind. 1982); *In re Christian*, 8 Bankr. 816 (Bankr. M.D. Fla. 1981). *But see* General Motors Acceptance Corp. v. Martella (*In re Martella*), 22 Bankr. 649 (Bankr. D. Colo. 1982); John v. First Tennessee Bank (*In re Burnette*), 14 Bankr. 795 (Bankr. E.D. Tenn. 1981).

It is clear, however, that § 547(c)(1) can be applied conceptually to secured transactions. An example would be where the debtor and creditor agree at the outset that security would be given for the loan and, in fact, was so given reasonably soon thereafter. The antecedency created by the brief delay in the transfer of security is quite obviously not the "type" of antecedency which § 547 seeks to attack. The exception of the trustee's avoidance power was recognized under the old act as well. *See* Dean v. Davis, 242 U.S. 438 (1917) (delay between the value and transfer (mortgage) of seven days).

- (1) to the extent that such transfer was—
- (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
 - (B) in fact a substantially contemporaneous exchange.⁷⁶

The legislative history and commentary reveal that this section was primarily directed to the debtor who pays by check.⁷⁷ The transferee may have given the consideration, a car for example, and may have accepted the debtor's check as payment for the goods. Although a check is commonly treated as a cash transaction, in reality it is a credit transaction.⁷⁸ The drafters, therefore, created a defense for those parties who take a check as payment for goods.

Suppose, however, that the check bounces. After two months, Creditor resubmits the check or Debtor issues another one within 90 days of his bankruptcy. This time the check clears. Under these facts it is very doubtful that subsection (c)(1) would apply.⁷⁹ The exchange is not "in fact a substantially contemporaneous" one as the section requires. One can argue, however, that new section 547(c)(2) could apply under certain circumstances. Some debtors have an unfortunate habit of submitting NSF checks. Their creditors may have no choice but to resubmit them. These transactions may very well be according to "ordinary course of business" and within "ordinary business terms."⁸⁰

76. 11 U.S.C. § 547(c)(1) (1982).

77. The first exception is for a transfer that was intended by all parties to be a contemporaneous exchange for new value, and was in fact substantially contemporaneous. Normally, a check is a credit transaction. However, for purposes of this paragraph, a transfer involving a check is considered to be "intended to be contemporaneous," and if the check is presented for payment in the normal course of affairs, which the Uniform Commercial Code specifies as 30 days, U.C.C. section 3-503(2)(a), that will amount to a transfer that is "in fact substantially contemporaneous."

H.R. REP. NO. 595, 95th Cong., 1st Sess. 373-74 (1977). See also Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 186 (1979).

78. U.C.C. § 3-409 generally provides that "[a] check or other draft does not of itself operate as an assignment of any funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until he accepts it." Until payment or acceptance of the check, the payee has only an expectancy of payment.

79. The legislative history supports the position that a bounced check does not receive § 547(c)(1) protection: "Contrary to language contained in the House Report, payment 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 the check is delivered for purposes of sections 547(c)(1) and (2)." 124 CONG. REC. 34,000 (1978) (emphasis added).

80. For example, in *Ewald Bros., Inc. v. Kraft, Inc.*, 45 Bankr. 52 (Bankr. D. Minn. 1984), the court held that tendering and resubmission of three NSF checks did not satisfy the "ordinary course" requirement.

Plaintiff and Defendant established a course of business of making payments on their debts through check transfers. Prior to [the year of bankruptcy], Plaintiff had never submitted payment in the form of an NSF check. Moreover, while there was some evidence indicating that payment by NSF check might have occurred on two other occasions . . . such should not suffice to alter an already established and substantially continuing payment practice.

Id. at 57-58.

While the court did not believe that a course of dealing had been established, more instances of the creditor taking NSF checks likely would have forced the court to accept the defense.

Subsection (c)(4) also was not amended in 1984. That section gives preferred creditors a set-off against the trustee's preference claim for any credit given the debtor after the creditor has received a preferential transfer. A defense is available

- (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
- (A) not secured by an otherwise unavoidable security interest; and
 - (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.⁸¹

Judge Swartzberg's opinion in *In re Rustia*⁸² is helpful in explaining the application of this section. In *Rustia*, the debtor filed bankruptcy on November 18, 1981. One of the creditors was VISA. Within the crucial 90-day period before bankruptcy, Debtor made the following payments and charges:

Payment	Charge
\$163.00 September 9	\$225.00 September 17
\$ 83.00 September 15	\$ 84.00 October 30

In addition, within the 90-day period the following payments and charges were made with Mastercard:

Payment	Charge
\$ 83.00 September 9	\$250.00 September 15
\$ 81.00 September 15	\$ 88.00 October 30

Both creditors were claiming defenses under subsections (c)(1), (c)(2), and (c)(4). Judge Swartzberg disposed of the subsection (c)(1) defense quickly.⁸³ He also ruled that the subsection (c)(2) argument ran afoul of the 45-day limitation because the payments could not be traced to any specific purchases.⁸⁴ He did, however, give limited protection under subsection (c)(4).

81. 11 U.S.C. § 547(c)(4) (1982).

82. 20 Bankr. 131 (Bankr. S.D.N.Y. 1982).

83. *Id.* at 133-34. The credit card companies argued that the debtor's outstanding credit limit was \$2,000.00. Payments were made to reduce the balance below \$2,000.00, thereby permitting the debtor to make further charges. The card companies argued, therefore, that there was a "contemporaneous exchange": the debtor paid the companies, and, in exchange, they permitted the debtor to make further charges. Judge Swartzberg ruled that this was not the kind of "contemporaneous exchange" contemplated by the section. "The availability of credit is not synonymous with the extension of credit; the estate is not augmented by the fact that the debtors' payments resulted in restoring their line of credit to the extent of the payments." *Id.* at 134.

84. *Id.* at 134-35.

VISA had given new value on September 17 in the amount of \$225.00 *after* the preferential payments made on September 9 and 15. That \$225.00 extension of credit was “netted” against the two prior payments thereby limiting the trustee’s recovery to \$21.00.⁸⁵ The Mastercard payment of \$250.00 was greater than the prior preferential payments and, therefore, Judge Swartzberg ruled that when the new value was netted against the preferential payments, no recovery against Mastercard was available. As to the charge occurring on October 30, however, the trustee was able to recover that \$88.00 in its entirety. The September 17 charge did not come *after* the October 30 payment, as section 547(c)(4) required, and therefore could not be netted against the October 30 payment.

While Judge Swartzberg correctly applied section 547(c)(4),⁸⁶ the value of his opinion, in light of the amendment to section 547(c)(2), is unclear. Recall that the court’s only basis for not applying subsection (c)(2) was the 45-day rule.⁸⁷ Virtually all payments to trade creditors, who may also be giving value as defined by section 547(c)(4) (e.g. credit card companies), are incurred and paid in ordinary course of business or financial affairs of the debtor and are paid according to ordinary business terms. What then remains of subsection (c)(4), practically speaking?

In addition, it appears that new section 547(c)(2) makes substantial inroads on the scope of subsection (c)(5). The 1978 code validated, by means of subsection (c)(5), the floating lien on the debtor’s inventory⁸⁸ and receivables,⁸⁹ but only to the extent that in the 90-day period prior to bankruptcy the secured creditor had not improved his position “to the prejudice of other creditors holding unsecured claims.”⁹⁰ It appears, however, that many

85. *Id.* at 135-36. The reader should also note that the 1984 amendments include a new subsection (c)(7) defense for transfers involving consumer debts that are less than \$600.00. The new subsection provides for a defense “if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$600.00.” 11 U.S.C.A. § 547(c)(7) (West 1979 & Supp. 1985). It seems clear that a transferee could combine a (c)(7) defense with other subsection (c) defenses. See *infra* note 103 and accompanying text. Thus, the transferees in *Rustia* could have used new subsection (c)(7) and subsection (c)(4) to eliminate their liability.

86. See *Leathers v. Prime Leather Finishes Co.*, 40 Bankr. 248 (D. Me. 1984) (rejecting the “net result rule”). Under the “net result” construction, all payments and credits are simply balanced against one another with the difference being the amount of recovery. is also given to the time the credits are given.

87. *Rustia*, 20 Bankr. at 134-35. Judge Swartzberg ruled that the debts and payments were incurred and made in the ordinary course of financial affairs of the debtor. He also ruled that they were to pay according to ordinary business terms. *Id.*

88. 11 U.S.C. § 547(a)(1) (1982) defines “inventory” as “personal property leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw materials, work in process, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease.”

89. 11 U.S.C. § 547(a)(3) (1982) defines “receivable” as a “right to payment, whether or not such right has been earned by performance.”

90. 11 U.S.C.A. § 547(c)(5) (West 1979 & Supp. 1985) provides a defense for a transfer (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition

payments made to the inventory and receivable financier that could have been recaptured before July 10, 1984, now are unavailable.

Assume, for example, that C_1 extended Debtor a \$1,000,000 line of credit on an unsecured basis. If it were understood between C_1 and Debtor that Debtor is to pay as he is able, then a \$100,000 payment made during the 90-day period likely would be made in ordinary course of business and according to ordinary business terms. Thus, the payment would be protected under section 547(c)(2).

Assume another creditor, C_2 , loans \$1,000,000 and, in addition, demands a security interest on inventory and receivables. Assume further that, on the 90th day prior to bankruptcy, the debt remains at \$1,000,000 with the value of inventory and receivables being \$900,000. Thus, there exists a \$100,000 insufficiency under the provisions of subsection (c)(5).⁹¹ If Debtor decided to pay C_2 \$100,000 on the eve of bankruptcy, then C_2 has improved his position to the extent of \$100,000, assuming that the amount of debt and the value of collateral remained constant. Prior to July 10, 1984, the trustee could have recovered the \$100,000 from C_2 since subsection (c)(5) offers no protection.⁹² Today, however, C_2 likely has a 547(c)(2) defense and the \$1,000 may not be recoverable. It is, of course, absurd and irrational to hold that C_2 , a creditor secured by inventory and receivables, should be given less protection than an unsecured creditor. Apparently, only secured transactions not involving inventory and receivables escape the effects of the 1984 amendment.

Congress must have intended that the other provisions of subsection (c) have some *practical* effect. Furthermore, it is unclear whether Congress intended more than to protect transferees who receive *timely* payment of unsecured obligations whether they be payments to trade creditors or payments on lump sum or installment notes. Yet in doing so, Congress may have unintentionally undermined other policies advanced by the other sub-

and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—

- (A) (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
- (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
- (B) the date on which new value was first given under the security agreement creating such security interest.

91. *Id.* Section 547(c)(5)(A)(i) requires the court to compare the secured party's position "90 days before the date of the filing of the petition" with his position "as of the date of the filing of the petition."

92. *Id.* The statute requires the court to consider the "aggregate of all such *transfers* . . ." 11 U.S.C.A. § 547(c)(5) (West 1979 & Supp. 1985) (emphasis added). Section 101(48), in stating that a "transfer" includes "every mode of . . . parting with property," makes clear that the payment of money constitutes a "transfer." 11 U.S.C.A. § 101(48) (West 1979 & Supp. 1985).

section (c) defenses. In the next section, the article discusses potential methods that the courts may use to limit the scope of amended section 547(c)(2).

IV. ARGUMENTS FOR LIMITING THE SCOPE OF 1984 SECTION 547(c)(2)

As preferential transferees will certainly rush to new section 547(c)(2), trustees will also quickly attempt to limit the scope of the new amendment. This section presents three of the most logical limitations, discussing both their strengths and weaknesses.

Some trustees may attempt to limit subsection (c)(2) by asserting that the subsection (c)(1) and (c)(4) defenses are exclusive. Thus, the argument runs that, in cases of conflict between (c)(2) and (c)(1) or (c)(4), the (c)(1) and (c)(4) defenses should control. Many courts have held that subsection (c)(3)'s enabling loan defense was the only defense available to secured creditors receiving purchase money security interests.⁹³ If subsection (c)(3) has been held to be an exclusive defense, then subsections (c)(1) and (c)(4) could be as well.

The Eleventh Circuit recently held that a creditor could not look to subsection (c)(1) when an "enabling loan"⁹⁴ was involved. In *Gower v. Ford Motor Credit Corp.*,⁹⁵ the debtor bought a Ford tractor from a Ford dealer on August 6, 1981. While the debtor's installment sales contract, an "enabling loan" under subsection (c)(3), was assigned to Ford Credit on August 11th, Ford Credit did not perfect until August 26th. Bankruptcy was filed on November 16, 1981. Unfortunately for Ford Credit, subsection (c)(3) required perfection within "10 days after the security interest attaches."⁹⁶ Thus, subsection (c)(3) provided no defense to the preference attack. Ford Credit argued that it had a defense under subsection (c)(1) in that a contemporaneous exchange was intended and that the exchange was in fact

93. See cases cited *supra* note 75.

94. Section 547(c)(3) provides that the trustee may not avoid a transfer

- (3) of a security interest in property acquired by the debtor—
 - (A) to the extent such security interest secures new value that was—
 - (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
 - (ii) given by or on behalf of the secured party under such agreement;
 - (iii) given to enable the debtor to acquire such property; and
 - (iv) in fact used by the debtor to acquire such property; and
 - (B) that is perfected before 10 days after such interest attaches.

11 U.S.C. § 547(c)(3) (1982).

The principal change to § 547(c)(3) in 1984 was to require that the secured party perfect within 10 days after the debtor "receives possession." 11 U.S.C. § 547(c)(3)(B) (West 1979 & Supp. 1985).

95. (*In re Davis*), 734 F.2d 604 (11th Cir.), *cert. denied*, 104 S. Ct. 1294 (1984).

96. 11 U.S.C. § 547(c)(3)(B) (1978). See *supra* note 94 for the language of the 1984 amendment to 547(c)(3)(B).

substantially contemporaneous. Judge Kravich would accept none of Ford's argument:

Congress gave no indication that a security interest for an enabling loan could qualify under subsection (c)(1). Rather, the statute and legislative history explicitly state that Congress intended 547(c)(1) to exempt transactions involving payment by check and the like, and that 547(c)(3) exempts credit transactions involving enabling loans.⁹⁷

To date, all of the reported cases discussing subsection (c) defenses have involved conflicts between subsections (c)(1) and (c)(3). No court has explicitly ruled on the application of 547(c)(2) to secured transaction cases.⁹⁸ But in addition to the enabling loan exception, sections 547(e)(1) and (e)(2),⁹⁹ which govern the time of transfer, generally accord the secured party only 10 days to perfect a security interest.¹⁰⁰ Permitting the secured party 45 days to perfect his security interest (as old section 547(c)(2) did) would render the more specific sections, which are directly applicable to secured transactions, meaningless.

Could the same argument be advanced regarding cases that fall within the narrowly defined defenses set forth in subsections (c)(1) and (c)(4)? Judge Kravich asserted that section 547(c)(1) was enacted to protect, among others, those transferees who are paid by check.¹⁰¹ Is subsection (c)(1) the *exclusive* defense for cases where the transferee is paid by check?

There are two principal problems with this approach. First, to adopt it would in effect write section 547(c)(2) out of the bankruptcy code. Section 547(c)(2) was originally designed to protect trade and other creditors, who are often paid by check.¹⁰² Limiting section 547(c)(2)'s applicability to cash cases would eliminate protection for most of those creditors. Moreover, if Senators Dole and DeConcini had anticipated that some bankruptcy court might rule that section 547(c)(2) did not protect payments by check, they might have constructed their Senate dialogue to include reference to check payments.

97. *Gower*, 734 F.2d at 607 (footnote omitted).

98. In *Brent Explorations, Inc. v. Karst Enterprises, Inc.* (*In re Brent Explorations, Inc.*), 31 Bankr. 745 (Bankr. D. Col. 1983), the court set aside a security interest because it was unperfected under non-bankruptcy law and therefore voidable under 544(a)(1). 11 U.S.C. § 544(a)(1) (1982). The court then ruled that payments made during the 90-day period prior to bankruptcy were preferential. Finally, the court assumed, without discussion, that the creditor had a right to "invoke" a § 547(c)(2) defense. 31 Bankr. at 752. Ultimately, however, the court ruled that the debt had been incurred beyond the 45-day period; therefore, § 547(c)(2) was not available. With the 45-day requirement now dropped, the creditor in *Brent Explorations* probably has a defense.

99. 11 U.S.C.A. § 547(e)(1), (2) (West 1979 & Supp. 1985). See *supra* note 74.

100. E.g., *In re Poteet*, 5 Bankr. 631 (Bankr. E.D. Tenn. 1980) (voiding as preferential a security interest on an automobile because it was perfected beyond the 10-day period).

101. See *Gower*, 734 F.2d at 607. See also *supra* note 77.

102. See *supra* notes 76 & 77 and accompanying text for pertinent legislative history.

Second, courts in pre-1984 amendment cases viewed the subsection (c)(1), (c)(2), and (c)(4) defenses as being cumulative.¹⁰³ Recall that in *In re Rustia*¹⁰⁴ Judge Swartzberg rejected the subsection (c)(1) and (c)(2) defenses.¹⁰⁵ His opinion, however, assumes that the subsection (c) defenses in non-secured transaction cases are cumulative. If it had not been for the existence of section 547(c)(2)'s 45-day limitation, then that section would have provided the transferees with a complete defense. Instead, the transferees were allowed only a partial defense under subsection (c)(4), with protection reduced to the extent that they had given new value. It seems clear from *Rustia* that credit card companies, with the removal of the 45-day limitation, now will be afforded a complete defense.

Similarly, subsection (c)(4) may not be the exclusive defense for cases in which new value is given after a preferential payment. First, as explained above, bankruptcy courts would have to back away from established precedent indicating that these defenses are cumulative. Second, making subsection (c)(4) the exclusive defense would defeat the very policy for that subsection.

Subsection (c)(4) was enacted to provide creditors an incentive to lend to debtors with the hope that the additional credit will keep them solvent. Thus, if *C*₁ were to receive a \$10,000 preferential payment and subsequently extend the debtor \$5,000 in *new* credit, then subsection (c)(4) would limit the trustee's recovery to only \$5,000. Section 547(c)(2), however, provides a total defense to the trustee's preference action, leaving the trustee with nothing. Making subsection (c)(4) the exclusive defense in those cases where new value is given would discourage creditors like *C*₁ from extending new credit. They would much prefer a total rather than partial defense to the trustee's preference action.

Having rejected suggestions that bankruptcy courts should make subsection (c)(1) and (c)(4) defenses exclusive, one should now turn to the language of the subsection to see if it can be reasonably limited in scope. The most obvious target is subsection 547(c)(2)(B)'s requirement that the "transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee." One possible limiting construction is to hold that a

103. The legislative history of § 547(c) states: "Subsection (c) contains exceptions to the trustee's avoiding power. If a creditor can qualify under any one of the exceptions, then he is protected to that extent. If he can qualify under several, he is protected by each to the extent he can qualify under each." H.R. REP. No. 595, 95th Cong., 1st Sess. 373 (1977). Various courts have looked to several subsection (c) defenses in analyzing a preference case. See, e.g., *Tidwell v. Atlanta Gas Light Co. (In re Georgia Steel, Inc.)*, 38 Bankr. 829 (Bankr. M.D. Ga. 1984); *Keydata Corp. v. Boston Edison Co. (In re Keydata Corp.)*, 37 Bankr. 324 (Bankr. D. Mass. 1983); *Rovzar v. Prime Leather Finishes Co. (In re Saco Local Dev. Corp.)*, 30 Bankr. 859 (Bankr. D. Me. 1983).

Subsection (c)(3), however, has generally been held to be the exclusive provision for enabling loan exceptions. If an "enabling loan" transferee is not protected under subsection (c)(3), then there is no protection under subsection (c)(1). See cases cited *supra* note 75; see *supra* text accompanying notes 73-75.

104. 20 Bankr. 131 (Bankr. S.D.N.Y. 1982).

105. *Rustia*, 20 Bankr. at 134-35. See *supra* text accompanying notes 82-87.

transferee who receives a payment "knowing" or having "reasonable cause to believe that the debtor was insolvent" is not receiving the payment in the ordinary course of its business or financial affairs. One might also be tempted to argue that payments received after maturity of the note or installment are not received in the ordinary course of business or financial affairs of the transferee. Engrafting a "reasonable cause to believe insolvency" test onto the payment has some appeal because it permits the trustee to recover some of those transfers which were recoverable before 1978. The creditors in *Barash*,¹⁰⁶ alleged that it was unfair to require repayment in situations where they were unaware of the debtor's financial difficulties. In situations where the trustee can prove that the creditor had reasonable cause to believe the debtor was insolvent, there would be no defense.

While this argument has superficial appeal, it is unacceptable given the obvious displeasure Congress has demonstrated with the "reasonable cause to believe insolvency" test. On two separate occasions the test has been discarded.¹⁰⁷ Since the express language of the test has been discarded, a court would be hard-pressed to read it back into the code, albeit in a different section. Additionally, this limitation suggests that the creditor is acting in bad faith if he is aware of the fact that he is receiving a preference. Traditionally, however, except in the bankruptcy setting, the giving or taking of a preference does not constitute bad faith.¹⁰⁸ In view of Congress' obvious displeasure with the "reasonable cause" test, it should not be used as a limitation on section 547(c)(2).

The third proposal deals with timely payments. Payments which are overdue are not made by the debtor and received by the creditor in the "ordinary course of business or financial affairs." This proposed limitation has appeal because it is directed to the precise concerns of the credit industry. Senators Dole and DeConcini, in their exchange on the Senate floor, emphasized that the payments they had in mind were those made at "maturity."¹⁰⁹ Thus, looking at the statutory language, it is tempting to conclude that payments not made at maturity, in the case of lump sum obligations, or in a timely manner, in the case of installment obligations, are not made and received in the "ordinary course of business or financial affairs" of the debtor and creditor.

Future creditors likely will counter with the following argument. The prevailing view before the 1984 amendment was that the "ordinary course" provision was not applicable to payments made in an untimely manner. There is nothing in the legislative history to the new amendment to suggest

106. *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981). See also *supra* text accompanying notes 47-60.

107. See *supra* text accompanying notes 36-40.

108. "[I]t is long-settled in commercial law that a debtor may voluntarily prefer one creditor over another . . ." *In re Thomas*, 7 Bankr. 389, 392 (Bankr. W.D. Va. 1980).

109. See *supra* text accompanying notes 65-66.

that this same language be construed differently. Therefore, the "ordinary course" provision need not be satisfied in the case of untimely payments.

The pre-amendment case, *In re Ferguson*,¹¹⁰ dealt with certain payments made by a debtor-pork farmer within 45 days of the date the debts were incurred. The trustee argued that one payment was "particularly large" as compared to the debtor's other payments. Therefore, the trustee asserted that that payment was not made in ordinary course of business. The court simply assumed, without discussion, that payments made within the 45-day period were protected.¹¹¹ When one looks at old section 547(c)(2), one can see how the courts concluded that the time of payment should be governed solely by the 45-day provision. Recall that draftsman Levin indicated that 45 days was selected as the statutory period because it approximated the normal trade billing cycle.¹¹² Moreover, the scant legislative history does not suggest that the post-amendment provisions of section 547(c)(2) should be given any new construction.

In addition, creditors will almost certainly point to the Senate Report.¹¹³ Recall that Congress was dissatisfied with the fact that creditors expecting payment on billing cycles in excess of 45 days were not protected from preference attacks.¹¹⁴ Removing the 45-day limit was designed to increase protection for trade creditors. If courts were to rule that untimely payments were not made in ordinary course of business, then cases such as *Ferguson* would require further analysis possibly leading to a denial of protection to trade creditors. For example, if a trade creditor extended credit "payable in 30 days," then a payment on the 40th day may not be protected.

One can see however that the courts will struggle to find some standard by which to apply subsection (c)(2). It is obvious from the preceding discussion that "ordinary course" will be an elusive standard to define and, in all probability, will drive the courts back to the "time" factor. It is clear from the Dole-DeConcini dialogue¹¹⁵ that, although the 45-day provision was excised from subsection (c)(2), the emphasis remained upon timeliness and

110. 41 Bankr. 118 (Bankr. E.D. Va. 1984). See also *In re Brown*, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982).

111. The *Ferguson* court read *In re Brown*, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982), as a case "where the court applied the 45-day exception rule to certain charges stating that a debtor may pay for any transaction occurring within the preceding 45-day period without fear of avoidance by the trustee." 41 Bankr. at 122. *Brown* cannot be read to support such a bold statement. See *supra* note 17.

112. "Forty-five days was selected as a normal trade cycle." Levin, *An Introduction to the Trustee's Avoiding Policies*, 53 AM. BANKR. L.J. 173, 186 (1979). It is far from clear, however, that Mr. Levin would approve of the *Ferguson* court's decision not to look at the "ordinary course" language or at untimely payments made within the 45-day period. "Congress treated as nonpreferential an *ordinary-course* payment of trade credit in the first 15 days of the month following the month in which the goods were shipped or services performed." *Id.* at 187 (emphasis added).

113. S. REP. No. 65, 98th Cong., 1st Sess. 60 (1983). For the text of the relevant portion of the report, see *supra* notes 64-66.

114. See *supra* notes 56-57 and accompanying text.

115. See *supra* text accompanying notes 65-66.

“maturity.” Drawing upon this legislative history, the courts may thus conclude that untimely payments are not made in the ordinary course of business dealings and are recoverable by the trustee. *Ewald Brothers, Inc. v. Kroft, Inc.*,¹¹⁶ is a significant pre-amendment case; unlike other cases involving late payments made within the 45-day period, *Ewald* squarely addressed the question of whether or not the “ordinary course of business” provision applied to those late payments.

In *Ewald*, the parties had established a practice of making and accepting payments one or two days late. The trustee argued, and the court agreed, that payments which were made seven to twelve days late did not reflect the ordinary course of dealings between the parties, even though the latter payments were within the 45-day limit then existing under section 547(c)(2). The court did not address the 45-day limit apparently because it concluded that, if the payment was not timely and therefore not in ordinary course, then the 45-day provision was not applicable.¹¹⁷

Congress, when amending section 547(c)(2), obviously had an opportunity to do more than remove the 45-day provision. It chose not to and left the remaining language unchanged, including the ordinary course of business provision. Congress, therefore, excised the 45-day limit to overrule cases such as *Barash*, where the primary issue was whether payments were made within 45 days of the incursion of the debt. The amendment did not disturb the analysis employed in *Ewald*, where timeliness, as between the parties, was crucial in determining whether the payment was made in ordinary course.

On balance, future bankruptcy courts should find *Ewald* appealing. By extending the “ordinary course” language to late payments, courts can place some practical limits on subsection (c)(2)’s scope. The reader should not assume, however, that all late payments will be held to be unprotected. In *Ewald*, the creditor routinely accepted payments that were a day or two late. While the court left unprotected payments that were seven to twelve days late, the inference is clear that a payment two days late would have been in “ordinary course of business” and, therefore, would have been protected.

In determining what constitutes “ordinary course” payments, pre-amendment courts focused solely on dealings between the particular debtor and creditor,¹¹⁸ rather than examining industry-wide practice or other debtor-creditor relationships. Of course, the very language of the statute directs the

116. 45 Bankr. 52 (Bankr. D. Minn. 1984). The opinion does not make clear that the agreement between creditor and debtor required payment in fewer than 45 days after delivery. This fact, however, has been confirmed. Telephone interview with Mr. Michael Schwartz, counsel for the trustee, by Professor Price (March 5, 1985). For a discussion of *Ewald*'s analysis of payment by resubmitting an NSF check, see *supra* note 80.

117. With the elimination of the 45-day provision, trustees can now make an even stronger argument: Timeliness is crucial to a determination that the payment was made according to ordinary business practices.

118. *E.g.*, *Amex Trading Co. v. Brown Feed & Chem. Co. (In re Amex Trading Co.)*, 37 Bankr. 793, 799-801 (Bankr. W.D. Tenn. 1984); *Thomas W. Garland, Inc. v. Union Elec. Co. (In re Thomas W. Garland, Inc.)*, 19 Bankr. 920 (Bankr. E.D. Mo. 1982).

court to the “business or financial affairs of the *debtor* and the *transferee*.”¹¹⁹ Thus, creditors who routinely and continuously accept payments 60 and 90 days late seem to be within the scope of the provision’s protection.¹²⁰

CONCLUSION

It is apparent that there is a clear and unavoidable tension between those who assert that there should be no preferential transfer liability for payment received in ordinary course of business and those arguing in favor of a fundamental bankruptcy policy—the equal treatment of creditors. Trade creditors will never abandon the position that they are “different” creditors and that they should not be required to return debtor’s monthly payment for supplies, gasoline, or utilities. Unsecured lenders will always maintain that they should not be required to repay those timely payments debtor makes every month. They do appear to be willing to concede, however, that there is possible liability if they are aware that the debtor is financially troubled at the time debtor makes the payments.

Others have wondered why the utility company and unsecured lenders should be permitted to keep the preferences while the debtor’s other creditors, such as his relatives and neighbors, cannot. They argue that there is nothing special about the position of utility companies and trade creditors that justifies preferential treatment and that Congress, by means of the distri-

119. 11 U.S.C.A. § 547(c)(2)(B) (West 1979 & Supp. 1985) (emphasis added). Recently a court decided not to embrace the statute’s literal language. In *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 41 Bankr. 985 (Bankr. D. Utah 1984), the debtor had been involved in a so-called “Ponzi” scheme wherein creditors were encouraged to “invest” in an enterprise which, in reality, was a pyramid with subsequent “investors” paying off the *initial* “investors.” Before the regulators could shut the debtor down, some of the initial investors were handsomely repaid. The court ruled that the repayments were not in ordinary course of business:

When these transactions are considered for what they actually were, irrespective of what the investors’ thought they were, these payments could not constitute transfers in the ordinary course of business of the debtors and made according to ordinary business terms. All of the transactions were unusual, extraordinary, and unrelated to any business enterprise whose protection was intended by the drafters of Section 547(c)(2).

41 Bankr. at 1014-15.

While one may sympathize with the court’s concern about the obnoxiousness of the debtor’s enterprise, it is clear that the payments were in ordinary course of business. Certainly there was nothing unusual about the creditor’s receipt of payment, and the debtor’s payment was in complete compliance with what it promised to do. *See also* *Thomas W. Garland, Inc. v. Union Elec. Co. (In re Thomas W. Garland, Inc.)* 19 Bankr. 920 (Bankr. E.D. Mo. 1982) (refusing to protect payments to a creditor who apparently had proven a “usual course of business” which was without structure, scheduled payments, or any other procedure consistent with sound business practice). There is nothing in the statute or legislative history, however, that suggests that only accepted business practices are to be protected.

120. Perhaps the credit card companies will be the main beneficiary of the elimination of the 45-day rule. Many of their customers regularly pay only a fraction of their bill. The companies routinely accept less than full payments so long as a portion of the outstanding balance is paid.

bution section of the bankruptcy code,¹²¹ should decide priorities for the payment of creditors.

The Bankruptcy Commission embraced the latter point of view and abandoned the "reasonable cause to believe insolvency" test. With the abandonment of this test, however, trade creditors preserved much of their protected status by persuading Congress to insert section 547(c)(2) into the 1978 code. This offered very little protection to those creditors regularly lending on an unsecured basis. The most recent amendment apparently was designed to restore protection to creditors buying commercial paper.¹²² In restoring trade creditors and unsecured lenders to their pre-1978 position, Congress appears inadvertently to have given far more protection than was requested or desired by trade creditors.

Certainly Congress did not consider or foresee the fact that subsection (c)(4) is now of little value and that the policies underlying subsections (c)(1) and (c)(5) have been substantially undermined. While the courts will use the "ordinary course of business or financial affairs" language as a limiting factor, the results are disquieting. Creditors who diligently conduct their affairs and insist on timely payment of debts will receive no protection when taking an occasional late payment. Creditors who are less diligent and who routinely take payments many days late have a powerful argument that such payments are protected. Thus, the policy of uniform treatment of creditors, a policy that the preference section was promulgated to promote, will be substantially subverted.

It is possible that after its struggle to resolve conflicting philosophies concerning bankruptcy court jurisdiction,¹²³ Congress was simply weary of looking at the bankruptcy code. Congress should, however, take another look at what it has done with section 547(c)(2). The problem could be easily solved by making one defense available for creditors who receive payments during a normal billing cycle and a separate defense available for creditors who receive timely payments on an installment note or who receive payments

121. 11 U.S.C.A. § 507(a) (West 1979 & Supp. 1985).

122. See *supra* note 66 and accompanying text.

123. See *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). In dismissing a suit for alleged breach of contract and warranty, the *Marathon* Court held that § 1471(b) of the Bankruptcy Act of 1978 unconstitutionally conferred Article III powers on bankruptcy judges. *Marathon*, 458 U.S. at 87. The Supreme Court originally stayed the judgment in *Marathon* until October 4, 1982, to give Congress time to respond to the decision. 458 U.S. at 88. Subsequently, an extension of the stay to December 24, 1982 was granted. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 459 U.S. 813 (1982). A second extension of the stay was requested by Congress, but denied by the Court. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 459 U.S. 1094 (1982). Congress, in turn, extended the original transition period of the 1978 Act to June 27, 1984 so that the status of bankruptcy courts would remain unchanged beyond April 1, 1984, the date the new Act's provisions were to have taken effect. See Snider, Rochkind, Green, Stein & Welford, *The Bankruptcy Amendments and Federal Judgeship Act of 1984*, 63 MICH. B.J. 775 (1984). A legislative stalemate over the status of bankruptcy judges continued until the final approval of the 1984 Act. A conference committee finally ironed out the differences on June 27th and 28th. The bill was approved by both houses of Congress on June 29th and was signed into law on July 10, 1984. *Id.* at 775.

at maturity in the case of a lump sum obligation. Until Congress promulgates further amendments to the Code, some bankruptcy courts will reluctantly rule that section 547(c)(2) provides a defense for overdue preferential payments to creditors who were fully aware of the precarious financial condition of the debtor.

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