Library

New Meaning of Ordinary: Anything Short of Extraordinary

By Pamela Egan Singer [1]

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act ("the Bankruptcy Reform Act")[2] has significantly bolstered the ordinary course of business defense to a preference action.[3] Under the new version of Bankruptcy Code section 547, a defendant can defeat a preference by proving (i) that the transfer was made in payment of a debt incurred by the debtor in the ordinary course of business and *either* (ii) that the transfer was made in the ordinary course of business between the debtor and the transferee *or* (iii) that such transfer was made according to ordinary business terms. Under case law developed before the Bankruptcy Reform Act was adopted (when defendants had to prove each of the foregoing elements), the third element of the ordinary course of business defense served as a "check" against the second element and as such was subject to a very low standard: anything that was not aberrational or idiosyncratic qualified. By elevating this "check" to a potentially dispositive test, Congress has arguably expanded the meaning of ordinary to include anything short of aberrations and idiosyncrasies and made it vastly easier to defeat a preference.

The Second and Third Elements Are Subject to Different Standards

The Subjective Test

The second element of section 547(c)(2) is often referred to as the "subjective test" and requires a showing that, as between the parties, the transfer was made in the normal course of their dealings.[4] Under the subjective test, courts compare the historical pattern and timing of payments by the debtor to the preference defendant, with the pattern and timing of such payments during the ninety days before the bankruptcy filing.[5] In comparing the parties' past practices to determine what was "ordinary" as between the parties, courts use a variety of measurements, including means, averages, and modes.[6] Courts also consider whether the debtor or creditor engaged in any unusual collection or payment activity and whether the creditor took advantage of the debtor's deteriorating financial condition.[7]

The Objective Test

The third element of the ordinary course defense is referred to as the "objective test." The objective test only requires a showing by the transferee that the transfers at issue conform to a broad range of practices within the applicable industry such that "only a transaction that is so unusual or uncommon as to render it an aberration in the relevant industry falls outside the broad range of terms encompassed by the meaning of ordinary business terms."[8] Similarly, the Seventh Circuit stated in the leading case of *Tolona Pizza Products*, "We conclude that 'ordinary business terms' refers to 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."[9]

This low standard that treated anything but aberrations and idiosyncrasies as ordinary reflected the

objective test's role as a "general backdrop against which the specific transaction at issue is evaluated" rather than as a "litmus test."[10] As stated in *Tolona Pizza*, "If the debtor and creditor dealt on terms that the creditor testifies were normal for them but that are wholly unknown in the industry, this casts some doubt on his (self-serving) testimony."[11] Similarly, evidence that the preference payment pattern between the parties has at least some precedent in the industry was seen as allaying concerns that the particular creditor had managed to work out extraordinary terms before the preference period that were designed to put that creditor ahead of others. *Id.*

The New Low Standard of Ordinary

By making the second and third elements disjunctive, the Bankruptcy Reform Act raises the "check" of the objective test to the level of a dispositive test, and thus arguably reduces the standard for ordinary course of business to anything that is not "aberrational" or "idiosyncratic" in the creditor's industry. Even in the face of creditor pressure, a defendant can now argue that as long as such pressure is not aberrational within the industry, the transfer was made in the ordinary course of business.

Plaintiffs may argue that because the objective test now stands on the same footing as the subjective test, courts should now hold the objective test to the same standard as the subjective test. That is, a transferee should have to prove that the transfer was consistent with the average transaction in the creditor's industry, rather than that it fits within a broad range of transactions. This argument, however, should run into the same practical, evidentiary problems that relegated the objective test to a backdrop in the first place. As the Seventh Circuit explained in *Tolona Pizza*, "not only is it difficult to identify the industry whose norms shall govern . . . but there can be great variance in billing practices within an industry."[12] Thus, definitive information with respect to industry standard is typically scarce. In *Molded Acoustical Products*, the Third Circuit added that a creditor trying to prove the objective test of the ordinary course analysis should not be "forced to depend upon information about its competitor's trade practices, information that the competitors oft will be reluctant to yield and that frequently the creditor will find difficult to obtain."[13] Both antitrust concerns and the vagaries within the industry have also been cited as impediments to proving a uniform pattern of transactions. As *Tolona Pizza* stated, "The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market."[14] Moreover, the legislative history is silent on any intent to overrule existing case law with respect to the ordinary course of business and generally courts are not to assume a Congressional intent to overrule governing case law absent express Congressional language.[15]

The Take Away

Defendants can now argue that notwithstanding a sharp departure from the parties' past practice, or even creditor pressure, if the transfer has some precedent in the industry (i.e., is not aberrational or idiosyncratic), it is protected by the ordinary course of business defense. Although plaintiffs may argue that the standard for the objective test should be strengthened, given that it is no longer a mere "check" but instead a dispositive test, this argument has no backing in the legislative history and will encounter the same practical and evidentiary hurdles that reduced the objective test's standard in the first place. Accordingly, the Bankruptcy Reform Act has created a potentially significant change in preference litigation to the distinct advantage of defendants.

Endnotes

[1] Pamela Egan Singer is Of Counsel to the law firm of Pachulski, Stang, Ziehl, Young, Jones & Weintraub P.C. and is resident in its San Francisco office. She practices in the areas of bankruptcy and litigation. She received her B.A. from Dartmouth College and her J.D. from Cornell University School of Law.
[2] Pub. L. No. 108-9. Generally, the Bankruptcy Reform Act applies to all bankruptcy cases that were filed on or after October 17, 2005.
[3] 11 U.S.C. § 547(c)(2).
[4] *Cocolat, Inc. v. Fisher Development, Inc. (In re Cocolat, Inc.)*, 176 B.R. 540, 549 (N.D. Cal. 1995).
[5] *Yvette Gonzales v. DPI Food Products Co. (In re Furrs Supermarkets, Inc.)*, 296 B.R. 33, 40-41 (D. N.M. 2003).
[6] *Unsecured Creditors Committee v. Manufacturers Consolidation Serv., Inc. (In re Color Tile, Inc.)*, 2000 WL 1373004 (Bankr. D. Del. Sept. 20, 2000) (using means, modes and averages under the subjective test).
[7] *Sulmeyer v. Suzuki (In re Grand Chevrolet, Inc.)*, 25 F.3d 728, 732-33 (9th Cir. 1994) (any unusual collection or payment activity by either the debtor or creditor is a factor for consideration in making a § 547 ordinary course evaluation).

[8] *Jan Weilert RV, Inc. v. Anderson (In re Jan Weilert, RV Inc.)*, 315 F.3d 1192, as amended, 326 F.3d 1028 (9th Cir. 2003) (emphasis added).
[9] In re *Tolona Pizza* Products Corp., 3 F.3d 1029, 1033 (7th Cir. 1993).
[10] *Miller v. Florida Mining & Materials (In re A.W. & Assoc., Inc.)*, 136 F.3d 1439, 1443 (11th Cir. 1998).
[11] *Tolona Pizza*, 3 F.3d at 1032.
[12] *Id.*, 3 F.3d at 1033.
[13] *Fiber Lite Corp. v. Molded Acoustical Products, Inc. (In re Molded Acoustical Products, Inc.)*, 18 F.3d 217, 224 (3d Cir. 1994).
[14] *Tolona Pizza*, 3 F.3d at 1033.
[15] *Midatlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection* , 474 U.S. 494, 501 (1986).