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# From the Bankruptcy Courts: Preferential Payment of Long-Term Debts in the Ordinary Course of Business-The Effect of the 1984 Amendments

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## PREFERENTIAL PAYMENT OF LONG-TERM DEBTS IN THE ORDINARY COURSE OF BUSINESS—THE EFFECT OF THE 1984 AMENDMENTS

Comprehensive changes made by the Bankruptcy Amendments and Federal Judgeship Act of 1984[1] have been well publicized. Title I of the Act reconstituted the bankruptcy court as a unit of the federal district court with limited jurisdiction and only fourteen-year judicial terms. Title III of the Act contains several subtitles, each one affecting a different segment of substantive bankruptcy law. "Consumer Credit Amendments," "Leasehold Management Amendments," "Amendments Regarding Repurchase Agreements," and "Collective Bargaining Agreements" are a few of the headings attached to subtitles that have received the most publicity.

### Subsection B Is Deleted

However, the practitioner should be aware of another important amendment to the Bankruptcy Code which was among numerous technical and substantive changes contained in a subtitle labeled "Miscellaneous Amendments to Title 11." We are referring to Section 462(c) of the 1984 Act which amended the voidable preference section of the Bankruptcy Code by deleting Section 547(c)(2)(B).[2] Prior to the recent amendment, Section 547(c)(2) read as follows:

> (c) the trustee may not avoid under this section a transfer
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> * * *
>
> (2) to the extent that such transfer was—
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> (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
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> (B) made not later than 45 days after such debt was incurred;
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> (C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

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[1] Pub. L. No. 98-353, *enacted* July 10, 1984.

[2] 11 U.S.C. § 547(c)(2).

(D) made according to ordinary business terms. . . .

The 1984 amendment deleted the forty-five-day provision (subsection (B)) so that a payment made by an insolvent debtor to a creditor within the ninety-day preference period could not be avoided if the debt was incurred in the ordinary course of business and the payment was made in the ordinary course of business and according to ordinary business terms, whether or not the debt was short term (45 days or less). The effect of this 1984 amendment is that the ordinary course of business exception to the preference rule now applies to long-term as well as short-term debt. To understand this welcome relief to lenders and other credit grantors, historical bankruptcy principles must be considered.

### Why Congress Did It

One of the cardinal principles of bankruptcy is equality of distribution of a debtor's assets among its general creditors. This goal cannot be achieved if a debtor is free to prefer favorite creditors by distributing assets unequally shortly before commencing a bankruptcy case. The vulnerable time period in which such unequal distributions are likely to be made is presumed to be ninety days prior to the filing of the bankruptcy petition. Although this seems to be an arbitrary time limit, Congress selected it as a reasonable cut-off date for creditors who are not insiders.[3]

Section 547 enumerates the elements of a preference, including any transfer of the debtor's property: (1) to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) while the debtor was insolvent; (4) made within ninety days of bankruptcy (except if the creditor is an insider); and (5) enabling the creditor to receive more than the creditor would have received in a liquidation case had the preferential payment not been made. All these elements must be proven by the trustee before the preferential payment can be avoided.

For example, assume that the debtor paid creditor *A*, a general unsecured creditor, $10,000 in partial payment of a debt of $20,000 within the ninety-day preference period, thereby giving the creditor 50 percent of the monies due it. Thereafter, bankruptcy ensued and the remaining assets of the debtor including the payment to creditor *A* would only realize in liquidation a dividend of 10 percent to general unsecured creditors. As a result, creditor *A*

[3] See 11 U.S.C. § 547(b). If the creditor is an "insider," the preference period extends to one year prior to the commencement of the case. See 11 U.S.C. § 101(25) for the definition of "insider." In cases filed prior to October 8, 1984, the one-year period applies to an insider only if the insider had reasonable cause to believe that the debtor was insolvent.

would have been preferred to the extent of receiving 40 percent more than other creditors of the same class. Assuming that all the other elements of a preference were present, creditor *A* must surrender its preferential payment and its claim would be allowed as a general unsecured claim to share pro rata with all other general unsecured creditors.

To protect payments made in the regular course of business from the harshness of this provision, Congress enacted Section 547(c)(2) which is set forth above.

> 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.[4]

## Seasons of Discontent

Section 547(c)(2) has been the subject of much litigation. Courts have had difficulty in applying the outer limits of the forty-five-day period contained in Section 547(c)(2) as originally enacted. Litigation has endeavored to resolve the problem of determining when the forty-five days commences. Was the debt "incurred" at the time the contract was signed, when the invoice was accepted, or on the date the goods were actually delivered to the purchaser.[5] "The commentators early noted that troublesome issues may arise in the judicial interpretation of the date that a debt is 'incurred.' "[6] Problems also arose as to whether the delivery of the check, as opposed to the date on which the check cleared the debtor's bank, was the date upon which the forty-five days terminated.[7]

The confusion of the interpretation of when a debt is incurred and when payment is deemed made, if made by check, far from leaving undisturbed normal financial relations, resulted in discontent in the commercial world. As a result, Congress eliminated Section 547(c)(2)(B) but left the remainder of the section intact. Thus, the trustee may not avoid a payment to the extent that the debt was incurred in the ordinary course of business or financial affairs of the debtor and the transferee, and the payment was made in the ordinary

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[4] S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978); see also H.R. Rep. No. 595, 95th Cong., 2d Sess. 373 (1978).

[5] See, e.g., *In re* Iowa Premium Serv. Co., 695 F.2d 1109 (8th Cir. 1982) (construing "incurred" as the date on which the debtor first became legally obligated to pay); see also the cases cited in the *Iowa Premium* decision.

[6] *In re* Emerald Oil Co., 695 F.2d 833, 836 (5th Cir. 1983).

[7] See, e.g., O'Neill v. Nestle Libbys P.R., Inc., ¶ (CCH) 69,742 (1st Cir. 1984) (holding that payment is considered to be made when the check is delivered); accord Shamrock Golf Co. v. Richcraft, Inc., 680 F.2d 645 (9th Cir. 1982). Contra *In re* Super Market Distributors Corp., 25 Bankr. 63 (Mass. 1982).

course of business or financial affairs of the debtor and the transferee and was made according to ordinary business terms, whether the debt was long or short term.

**Future Complications**

There is no doubt that this 1984 amendment will be extremely beneficial to credit suppliers. Since the amendment does not apply to pending cases and did not go into effect until October 8, 1984, there are no current citations to cases applying the amendment. However, we are not at rest. The interpretation of "ordinary course of business" may lead to further conflicting opinions. Assume a hypothetical case in which the debtor is granted credit terms of sixty days and the debtor pays in seventy days and has developed a course of conduct for such payments in the past with the acquiescence of the credit grantor. Will payment made within ninety days of bankruptcy and seventy days after the debt was incurred by the debtor be held to be in the ordinary course of business and according to ordinary business terms so as to constitute a defense to a preference action? In this case, business terms were agreed upon between the parties, but not observed. Can seventy-day payments be considered new business terms?

Prior to the adoption of the Bankruptcy Code, one commentator observed in connection with Section 547(c)(2):

> As a result of this exception [§547(c)(2)] . . . there will be great litigation about whether the debt was incurred in the ordinary course of [the debtor's and creditor's] business, whether the payment was in the course of [the debtor's and creditor's] business, and especially whether the payment was made according to ordinary business terms.[8]

With the emphasis still being placed on the "ordinary course of business," it behooves the credit grantor to take another look at the promptness of the payments made by their debtors.

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[8] Countryman, "Bankruptcy Preferences—Current Law and Proposed Changes," 11 U.C.C.L.J. 95, 102 (1978).