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From the Bankruptcy Courts: The Meaning of "Ordinary Course Of Business" Under the Bankruptcy Code-Vertical and Horizontal Analysis

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THE MEANING OF "ORDINARY COURSE OF BUSINESS" UNDER THE BANKRUPTCY CODE—VERTICAL AND HORIZONTAL ANALYSIS

It is often necessary for the bankruptcy courts to determine whether certain conduct is in the "ordinary course of business." This issue may arise in several different contexts. For example, if a trustee or debtor in possession is operating the debtor's business after a bankruptcy petition is filed, unsecured credit that is entitled to an administrative expense priority may be obtained "in the ordinary course of business" without the necessity of first providing notice and an opportunity to be heard in court. However, if such credit is not incurred in the ordinary course of business, notice and opportunity to be heard must be provided before the action is taken.[1]

Similarly, the Code allows a trustee or debtor in possession to continue to operate the debtor's business after a chapter 11 case is commenced. The continuation of the debtor's business requires the use of assets and may also require the sale or lease of property as well as other business transactions. As long as the transaction or the use, sale, or lease of property is in the ordinary course of business, Section 363(c)(1) allows the trustee or debtor in possession to act without the need for notice and a hearing. The trustee or debtor in possesion may also operate the business not in the ordinary course of business but only after notice and an opportunity to be heard are afforded.[2]

Another application of the "ordinary course of business" concept relates to the recovery of voidable preferences under Section 547. In general, the preference provisions of the Code are designed to prevent unusual payments or other transfers on the eve of bankruptcy which unfairly benefit some creditors at the expense of others. Normal prepeti-

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[1] 11 U.S.C. §§ 364(a), 364(b).

[2] 11 U.S.C. §§ 363(b)(1), 363(c)(1). See 11 U.S.C. § 363(c)(2), which prohibits the use of cash collateral without either consent or prior court authorization even if the proposed use is in the ordinary course of business.

tion payments to creditors should not be disturbed. For this reason, Section 547(c)(2) protects against attack as voidable preferences certain payments that are made in the ordinary course of business. Specifically, a transfer in payment of an antecedent debt is not a voidable preference to the extent that it meets the following three requirements: (1) it was in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee; (2) payment was made in the ordinary course of business or financial affairs of the debtor and the transferee; and (3) payment was made according to ordinary business terms.[3]

Although the scope and meaning of the phrase "ordinary course of business" is crucial in these contexts, the Bankruptcy Code fails to provide any definition or guidelines for identifying an ordinary course transaction. However, a recent decision of the bankruptcy court in the Southern District of New York provides a helpful method of analysis for approaching this issue as it relates to postpetition activity.

In an adversary proceeding in *In re Johns-Manville Corp.*,[4] the bankruptcy court considered the issue whether the debtor's retention of certain lobbyists was in the ordinary course of business under Section 363(c)(1).[5] Although the Bankruptcy Code does not provide a definition of "ordinary course of business," the court found that "[n]evertheless a synthesis of existing case law reveals a developing yet workable analysis to be used in deciding whether an activity is within the debtor's 'ordinary course of business.' The analysis, using 'vertical' and 'horizontal' components, embodies the elastic rehabilitation policies of the Code yet respects its boundaries."[6]

The Vertical Dimension

The court in *Johns-Manville* explained that the "vertical dimension" focuses on the debtor's transaction "from the vantage point of a hypothetical creditor and inquires whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit."[7] The court referred to a district court opinion in a prior case in the Southern District of New York,

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[3] 11 U.S.C. § 547(c)(2); see also Weintraub & Resnick, "Preferential Payment of Long-Term Debts in the Ordinary Course of Business—The Effect of the 1984 Amendments," 17 U.C.C. L.J. 263 (1985).

[4] 60 Bankr. 612 (S.D.N.Y. 1986).

[5] The court also considered the issue of whether the lobbyists were "professional persons" within the meaning of 11 U.S.C. § 327(a) so as to require prior court approval for their retention. The court held that the lobbyists were not "professional persons" for that purpose.

[6] 60 Bankr. at 616.

[7] *Id.*

In re James A. Phillips, Inc.,[8] for a description of the vertical dimension test (although the court in *Phillips* called it the "creditor expectation test"):

> The touchstone of "ordinariness" is . . . the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business. So long as the transactions conducted are consistent with these expectations, creditors have no right to notice and hearing because their objections to such transactions are likely to relate to the bankrupt's chapter 11 status, not the particular transactions themselves.[9]

Another opinion in which the vertical dimension test was rephrased may be found in *In re Waterfront Companies, Inc.*,[10] where the court articulated the test as whether the transaction is within the day-to-day business of the debtor "without some kind of separate authorization."[11] The *Waterfront* court noted that "some transactions either by their size, nature or both are not within the day-to-day operation of a business and are therefore extraordinary."[12] Applying this test, the court held that an indemnity agreement which required shareholder approval was not entered into in the ordinary course of a debtor's business.

The first area to investigate in applying the vertical dimension test is the debtor's prepetition business practices and conduct. The nature of the debtor's prepetition conduct may be compared to its postpetition conduct with respect to ordinary course of business determinations under Section 363 or 364. For example, in *In re DeLuca Distributing Company*,[13] the bankruptcy court found that it was in the ordinary course of business for the debtor in possession to bargain for and enter into a new collective bargaining agreement, in view of the fact that the employees were covered by a collective bargaining agreement prior to the commencement of the reorganization case.

The *Johns-Manville* court emphasized that the primary focus of the vertical dimension is on the debtor's internal operation, beginning with prepetition conduct. However, prepetition activities provide only a starting point in evaluating postpetition activity. The court also must consider the changing circumstances inherent in the hypothetical creditor's expectations. "Viewed in this manner, changes between prepetition and postpetition business activity

[8] 29 Bankr. 391 (S.D.N.Y. 1983).
[9] *Id.* at 394.
[10] 56 Bankr. 31 (D. Minn. 1985).
[11] *Id.* at 35.
[12] *Id.*
[13] 38 Bankr. 588 (N.D. Ohio 1984).

alone are not per se evidence of extraordinariness."[14] The court went on to emphasize the importance of allowing a degree of flexibility to cope with changing business conditions while still acting in the ordinary course of business:

> The "ordinary course of business" standard is purposely not defined so narrowly as to deprive a debtor of the flexibility it needs to run its business and respond quickly to changes in the business climate. Title 11 procedures are not meant to straitjacket a debtor, and a debtor must be allowed to marshall assets on an "as needed" basis. The policy behind the Code recognizes that the debtor needs a certain degree of freedom on its road to reorganization so that it might avoid precisely those pitfalls which brought it into bankruptcy initially.[15]

The Horizontal Dimension

The "horizontal dimension" applied by the court involves an industrywide perspective. "[T]he primary focus of the horizontal analysis is external—this business vis-à-vis similar businesses."[16] This method of analysis developed more recently than the vertical dimension. As stated by the court in *Waterfront*, the question to be decided is "whether a type of transaction is in the course of *that debtor's business* or in the course of some other business."[17]

Vertical and Horizontal Analysis Applied to *Johns-Manville*

Based on this method of analysis, the court in *Johns-Manville* held that Manville's lobbying activities were clearly in the ordinary course of business. Manville had engaged in lobbying efforts long before the filing of the chapter 11 petition. "Thus, applying the vertical dimension, based on Manville's past history of lobbying, it is logical to assume that its creditors would reasonably expect Manville to continue to lobby as a business practice."[18] The court also found that lobbying met the requirements of the horizontal dimension. "An examination of other 'Fortune 500' companies reveals that a substantial number of them routinely lobby, maintain offices in Washington, D.C., and supplement their in-house staff with outside consultants."[19]

The expansive construction of "ordinary course of business" applied in *Johns-Manville* provides debtors in chapter 11 cases with appropriate flexibility and discretion to exercise reasonable business judgment in continuing their usual business practices, and

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[14] 60 Bankr. at 617.
[15] *Id.*
[16] *Id.* at 618.
[17] *Id.*
[18] *Id.*
[19] *Id.* at 619.

to conform to industrywide norms without the need for prior notice and the hearing. At the same time, it satisifes the Code's policy that only extraordinary postpetition transactions different from those that might be reasonably expected to take place need be brought to the attention of creditors and other interested parties to allow the voicing of objections.[20]

[20] See *In re* James A. Phillips, Inc., 29 Bankr. at 391.