From the Bankruptcy Courts: When Being Delinquent Is Ordinary: The Eighth Circuit Expands the “Ordinary Course of Business Exception” under Section 547(C)(2) of the Bankruptcy Code

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WHEN BEING DELINQUENT IS ORDINARY: THE EIGHTH CIRCUIT EXPANDS THE "ORDINARY COURSE OF BUSINESS EXCEPTION" UNDER SECTION 547(c)(2) OF THE BANKRUPTCY CODE

The preference provision of the Bankruptcy Code is designed to avoid payments or other transfers that unfairly benefit some creditors at the expense of others on the eve of bankruptcy. This provision, found in Section 547 of the Code, is consistent with a basic policy that underlies the Code—equality of treatment among creditors who are similarly situated.

An important exception to the trustee’s power to avoid a preferential payment made before bankruptcy is the so-called “ordinary course of business exception.” This exception was put in the Code so that normal prebankruptcy business regulations and transactions are not disturbed by the application of Section 547(b). Specifically, a transfer in payment of an antecedent debt is not a voidable preference to the extent that it meets the following three requirements. First, the debt must have been incurred in the ordinary course of business or financial affairs of the debtor and the creditor. Second, the payment must have been made in the ordinary course of business or financial affairs of the debtor and the creditor. The third requirement is that the payment must have been made according to ordinary business terms.

Statutory amendments and judicial developments during the past decade have greatly expanded the ordinary course of business exception. Prior to the 1984 amendments to the Code, the ordinary course of business exception applied only to payments made within forty-five days after the debt was incurred. In 1991, the Supreme Court in *Union Bank v. Wolas* held that the exception is now applicable to long-term debts as well as to short-term obligations. Most recently, the Court of Appeals for the Eighth Circuit in *In re U.S.A. Inns of Eureka Springs*,
Arkansas expanded the scope of the ordinary course of business exception even further when it held that the requirement of Section 547(c)(2) that the payments be made according to "ordinary business terms" may be satisfied where the debtor made late payments in conformity with the industry-wide practice in dealing with delinquent borrowers—rather than limiting the exception to payments made in conformity with the usual practice for financially healthy debtors.

The Facts

U.S.A. Inns of Eureka Springs, Arkansas assumed liability under a $2.7 million collateralized promissory note payable to United Savings and Loan Association. The note required the payment of equal monthly installments in the sum of $27,940. When U.S.A. Inns filed a bankruptcy petition, United's claim against it amounted to approximately $2.8 million and was secured by collateral worth $2.6 million. Within the ninety-day period prior to bankruptcy, U.S.A. Inns made several payments that were irregular as to both time and amount—none of the payments during that period equalled the full amount of the monthly installment that was due. When the bankruptcy trustee commenced an action against United to recover these payments, the parties stipulated that all the elements of a voidable preference listed in Section 547(b) had been met. However, the parties contested whether the ordinary course of business exception under Section 547(c)(2) was available as a defense.

The bankruptcy court found that the creditor met its burden to prove the first two prongs of Section 547(c)(2). That is, that the debt was incurred and the payments were made by the debtor in the ordinary course of business. However, the bankruptcy court held that, with respect to the third prong of the exception, United failed to produce any evidence on the issue of whether the payments had been made according to "ordinary business terms." The bankruptcy court reasoned that the question of whether payments were made according to ordinary business terms is one that "requires an objective determination whether the payments are ordinary in relation to the standards prevailing in the relevant industry." The bankruptcy court held that United did not present any evidence that the late note payments were so common within the savings and loan industry that they could be considered an ordinary business practice and, therefore, the exception in Section 547(c)(2) was not a valid defense. The bankruptcy court then granted

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4 9 F.3d 680 (8th Cir. 1993).


7 In re U.S.A. Inns of Eureka Springs, Ark., note 5 supra, at 491.
a $63,000 judgment in favor of the trustee.

The district court reversed the bankruptcy court’s decision. First, it held that the bankruptcy court erred when it required objective evidence of industry practice for the purpose of determining whether the payments were made on ordinary business terms. The district court reasoned that, under binding authority in the Eighth Circuit, the “ordinary business terms” requirement found in Section 547(c)(2)(C) is satisfied “so long as the late payments were consistent with the course of dealings between the debtor and creditor.”

Second, the district court held that the bankruptcy court’s finding that United failed to prove that the payments were made according to ordinary business terms was clearly erroneous.

The Relevance of Industry-Wide Practice

The court of appeals disagreed with the district court’s holding that evidence of industry-wide practice is irrelevant in determining whether payments were made according to “ordinary business terms.” Analyzing the law in that circuit, as well as the prevailing case law in other circuits, the court of appeals held that the bankruptcy court was correct when it held that a creditor relying on the “ordinary course of business exception” under Section 547(c)(2) must prove that payments received were made in accordance with the ordinary business terms in the industry.

Although the court of appeals agreed with the standard used by the bankruptcy court in determining whether Section 547(c)(2) was applicable, it disagreed with the bankruptcy court’s application of that standard in this case and, therefore, affirmed the district court’s reversal of the bankruptcy court’s decision. It is this part of the court of appeals decision that greatly expands the scope of the ordinary course of business exception.

Focusing on Industry Practice for Delinquent Borrowers

In determining whether United produced sufficient evidence that the prepetition payments conformed to the industry-wide standards so as to justify a finding that they were made according to “ordinary business terms,” the court of appeals focused on whether the payments were “ordinary” for delinquent borrowers, rather than focusing on whether they conformed to the usual practice of healthy borrowers. In particular, the court focused on the testimony of one witness—the chairman, president, and chief executive officer of United—who testified that it was the regular practice in the savings and loan industry to
work with delinquent customers as long as some type of payment was forthcoming. He testified that United was encouraged and directed by regulatory authorities to work with borrowers in the “so-called real estate crisis that is going on across the country,” and that the Office of Thrift Supervision directed United to work with delinquent borrowers in a manner that conformed to the industry-wide standards for dealing with troubled loans. He also testified that the late payments from U.S.A. Inns were made in a manner that “could be ordinary on those accounts . . . where there is default, delinquency and there is a workout process. . . .” Moreover, he testified that “probably eight to ten percent” of United’s accounts were on a similar pay schedule as U.S.A. Inns.

Recognizing that “[w]hat constitutes ‘ordinary business terms’ will vary widely from industry to industry,” the court of appeals noted that it is common practice in the savings and loan industry to work with delinquent debtors in a way that is consistent with United’s treatment of U.S.A. Inns. Therefore, the manner in which the late payments in this case were made was not particularly unusual in that industry. “[W]e feel the focus of subsection (c)(2)(C) should be on whether the terms between the par-

dies were particularly unusual in the relevant industry, and that evidence of a prevailing industry practice among similarly situated members of the industry facing the same or similar problems is sufficient to satisfy subsection (c)(2)(C)’s burden.”

The court also agreed with the loose standard recently formulated by the Court of Appeals for the Seventh Circuit in *In re Tolona Pizza Products Corp.*, where the court held that the phrase “ordinary business terms” in Section 547(c)(2)(C) “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).” Applying the standard set forth in *Tolona Pizza*, the court of appeals in *U.S.A. Inns* found that the testimony of United’s chairman, president, and chief executive officer “was sufficient to satisfy United’s burden of proving industry-wide practice dealing with real estate trouble loans” and had established

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13 Id.
14 Id.
15 Id.
16 3 F.3d 1029 (7th Cir. 1993).
17 Id. at 1033. Although the court of appeals in *Tolona Pizza* adopted a loose standard for determining whether payments conformed to ordinary business terms in the industry, the dissenting judge, while agreeing with that standard, could not conclude that the creditor in fact made the requisite showing for Section 547(c)(2)(C) to apply.
that United "was following the pre-
vailing practice among similarly-
situated savings and loans with de-
linquent customers to satisfy sub-
section (c)(2)(C)'s burden. The
terms on which United dealt with
U.S.A. Inns were not so ‘idiosyn-
cratic’ or ‘extraordinary’ as to fall
outside the broad scope of subsection
c(2)(C).’’ United "has car-
rried its burden of proof of demonstr-
ating conformity with industry
practice in dealing with late loan
payments, and it has satisfied the
objective requirement of subsection
(c)(2)(C) by showing that such late
loan payments are common within
the savings and loan industry and
that it is considered ordinary busi-
ness practice.’’ Therefore, the
bankruptcy court erred in awarding
the money judgment against United.

Conclusion

We agree that Section 547(c)-(2)(C)
requires the court to con-
sider industry-wide practices when
determining whether prepetition
payments were made "according to
ordinary business terms.’’ Howev-
er, construing the phrase "ordinary
business terms" in Section
547(c)(2)(C) to include usual indus-
try practices dealing with delinquent
borrowers, rather than healthy cus-
tomers, could severely limit a trust-
ee’s ability to recover otherwise
voidable preferences. Late and ir-
regular payments by debtors could
be found to be "ordinary’’ so long
as other delinquent debtors in that
industry usually act in a similar
manner.

It is too early to predict whether
U.S.A. Inns will be followed in most
other circuits or whether it will be
broadly construed even within the
Eighth Circuit. Perhaps it will be
applied only in troubled industries,
such as the savings and loan industry
plagued by delinquent real estate
mortgage loans.

It is not surprising to these au-
thors, however, that only two
months after the decision in U.S.A.
Inns, the Court of Appeals for the
Tenth Circuit in In re Meridith Hoff-
man Partners expressly rejected
the construction of the phrase "or-
dinary business terms’’ used in
U.S.A. Inns in a case where the
debtor made prepetition payments
under an escrow arrangement estab-
lished after the debtor defaulted on
a real estate mortgage loan. The
court in Meridith Hoffman held that
ordinary business terms are "the
kinds of terms that creditors and
debtors use in ordinary circum-
stances, where debtors are healthy. . . . ‘’ This construction is
consistent with the purpose of the
ordinary course of business excep-
tion, which is "to leave undisturbed
normal financing 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

18 In re U.S.A. Inns of Eureka Springs,
19 Id. at 686.
20 12 F.3d 1549 (10th Cir. 1993).
21 Id. at 1553.
debtor's slide into bankruptcy.'" The court in *Meridith Hoffman* stated that "even arrangements that creditors commonly try to use when a debtor is struggling may give a creditor an advantage over others and precipitate bankruptcy. For example, filing a lawsuit to enforce a debt may not be unusual when a debtor does not pay, but payments according to a settlement agreement are not according to ordinary business terms.""
From the Bankruptcy Courts

The court in *Meridith Hoffman* stated that “[e]ven arrangements that creditors commonly try to use when a debtor is struggling may give a creditor an advantage over others and precipitate bankruptcy. For ex-


ample, filing a lawsuit to enforce a debt may not be unusual when a debtor does not pay, but payments according to a settlement agreement are not according to ordinary busi-

23 In re *Meridith Hoffman Partners*, note 20 *supra*, at 1553.