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The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code

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THE TRUSTEE VERSUS THE TRADE CREDITOR: A CRITIQUE OF SECTION 547(c)(1), (2) & (4) OF THE BANKRUPTCY CODE

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I. INTRODUCTION

The Bankruptcy Code,[1] like its predecessor the Bankruptcy Act, permits the trustee to avoid certain preferential transfers made or suffered by the bankrupt[2] just prior to bankruptcy.[3] Generally, any transfer relating to an antecedent debt made to or for a creditor by an insolvent within ninety days before the filing of the bankruptcy petition is avoidable by the trustee.[4] The trustee may sue the cred-

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1. In this article "Bankruptcy Code" or "Code" refers to Title 11 of the United States Code enacted as part of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-51, 326 (Supp. V 1981)). "Bankruptcy Act" or "Act" refers to the former Title 11, 11 U.S.C. §§ 1-1103 (1976), repealed by the Bankruptcy Reform Act.

2. Or, more properly the "debtor." Bankruptcy Code § 101(12), 11 U.S.C. § 101(12) (Supp. V 1981). To avoid confusion, the term "debtor" will be used to describe an obligor, and "bankrupt" to describe a person subject to proceedings under the Code.

3. The Code, unlike the Act, does not make any formal distinction between preferences and voidable preferences. In this article, preferential transfer refers to any transfer which benefits one creditor at the expense of others. Those preferential transfers made voidable by the Code are referred to as preferences.

4. Bankruptcy Code § 547, 11 U.S.C. § 547 (Supp. V 1981). The operative provision is § 547(b), which states:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—
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> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

itor to recover the preference.[5] In addition, the preferred creditor will not be entitled to any dividend from the estate until the preference is repaid.[6]

This scheme is generally justified as both a means of discouraging creditors from dismembering the debtor and as a method of enforcing equal distribution among creditors.[7] It can, however, have some possibly unintended and undesirable side effects. Because only those preferential transfers received shortly before bankruptcy are voidable, some creditors institute aggressive collection actions hoping the debtor will survive the necessary ninety days. Such actions can end any chance that the debtor might have had to resolve its financial problem short of bankruptcy. Moreover, some creditors simply refuse to deal with financially troubled debtors, in part because any payments received from them may have to be disgorged.

The risk of precipitous creditor action is particularly acute if the debtor is a business. The reason is simple. Generally, when a business files for liquidation under Chapter 7, [8] or reorganization under Chapter 11[9] of the Code, it has long been insolvent.[10] The business

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(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Id. § 547(b).

5. *Id.* §§ 547(b), 550(a).

6. *Id.* § 502(d). "[T]he court shall disallow any claim of any entity . . . that is a transferee of a transfer avoidable under . . . section 547 . . . of this title, unless such . . . transferee has paid the amount . . . for which such . . . transferee is liable under . . . section 550. . . ." *Id.*

7. *See generally* 4 J. Collier on Bankruptcy ¶ 547.03 (L. King 15th ed. 1983).

8. Bankruptcy Code §§ 701-766, 11 U.S.C. §§ 701-766 (Supp. V 1981).

9. *Id.* §§ 1101-1174.

is frequently not paying its creditors on time, if at all, and those it does pay during the last ninety days of its existence will nearly always be preferees. During this period of decline, however, the debtor and some of its trade creditors will often attempt to reach an agreement whereby the debtor will reduce its prior indebtedness in exchange for the right to make further purchases. A regular supplier, unwilling to lose an important account, will often enter into some form of extension, payment, or shipment arrangement with its failing buyer. Such arrangements may be formal or informal; they may be as simple as making all future sales C.O.D. or as complex as the mind can imagine. Without such an arrangement, crucial suppliers may refuse to deal with the debtor. Often the debtor will then be unable to continue in business. Bankruptcy—voluntary or involuntary—may follow, with the attendant loss to all creditors.

Unfortunately for the trade creditor, except for those plans which encompass only prepaid or C.O.D. sales and provide for no payments on the overdue account,[11] such arrangements nearly always include preferential transfers. If these transfers are ultimately avoidable in bankruptcy, the possibility of a creditor entering a workout agreement and continuing to deal with the debtor may be reduced. For example, assume that Trade Creditor, Inc. agrees to continue to sell widgets to Failing Buyer, Inc. upon the

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10. "Insolvency" for preference purposes is defined in accordance with the "balance sheet" test. *Id.* § 101(26). This section states:

(26) "insolvent" means—

> (A) with reference to an entity other than a partnership, 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 such entity's creditors; and
>
> (ii) property that may be exempted from property of the estate under section 522 of this title; and
>
> (B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation—
>
> (i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and
>
> (ii) the sum of the excess of the value of each general partner's separate property, exclusive of property of the kind specified in subparagraph (A)(ii) of this paragraph, over such partner's separate debts . . . .

Id.

11. Prepayments and C.O.D. payments are not preferences because they are not made on account of an antecedant debt. *See id.* § 547(b)(2).

condition that each order is accompanied by payment for the oldest outstanding invoice. This arrangement enables Failing Buyer to stay in business for an additional eight months, and perhaps even to turn a profit. The inevitable occurs when Secured State Bank declares Failing Buyer's inventory loan in default. Virtuous Trustee, looking for some assets to increase the estate (and thus his potential compensation[12]) discovers that preferential transfers have been made to Trade Creditor. Trade Creditor is now forced to disgorge those transfers. Needless to say, Trade Creditor is not amused by this and will protest, with some justification, that it wore the white hat. After all, had it not continued to sell to Failing Buyer, all that would have been accomplished would have been an earlier bankruptcy.

It is this problem—that of the trade creditor attempting to deal with a failing, but not yet bankrupt, business—that is the subject of this article. In theory at least, trade creditors will be more likely to deal with a faltering buyer if they have some reasonable protection against liability in a subsequent preference suit.[13] Such continuation of business is desirable because it may well permit the buyer to restructure its operations outside of bankruptcy, thereby avoiding the cost of bankruptcy and ultimately permitting greater payment to all creditors. It has been asserted that section 547(c)(2) of the Bankruptcy Code was enacted with the problem of encouraging extensions of credit to faltering debtors in mind.[14] That sec-

12. The trustee's maximum compensation is limited to a fixed percentage of the moneys disbursed or turned over by the trustee to parties in interest other than the debtor. *Id.* § 326(a).

13. This, admittedly, is true for only some trade creditors—those who know of the debtor's financial problems. These "conscious preferees" are the only ones who could possibly be influenced in their decision to deal or not to deal with the debtor by preference exceptions. On the other hand, "unconscious preferees," who do not realize that the debtor's financial state is precarious, will presumably deal with the debtor anyway. Paradoxically, it is the unconscious preferee who has been more thoroughly protected.

14. *See, e.g.*, Note, *Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978*, 65 IOWA L. REV. 209, 235-37 (1979). In fact, it is not at all clear that this is the case. The Senate Judiciary Committee, in describing this provision, spoke of leaving "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." S. REP. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5874 [hereinafter cited as S. REP. No. 989]. This can be read as saying that § 547(c)(2) was not designed to *encourage* anything—but merely to avoid penalizing unconscious preferees. The sparse legislative history of this provision is discussed in Tait & Williams, *Bankruptcy Preference Laws: The Scope of Section 547(c)(2)*, 99 BANKING L.J. 55, 58-59 (1982). The authors note that, to some extent, § 547(c)(2) may have originated as a means of alleviating the impact of abolishing the require-

tion, which creates an exception to the general preference rule stated above, makes certain ordinary course transfers non-voidable.[15] In addition, two other preference exceptions, sections 547(c)(1) and 547(c)(4), can also be of use to the trade creditor. The first of these makes certain substantially contemporaneous transfers non-voidable.[16] The second permits a preferee to "set off" certain subsequent advances of credit against a preference.[17]

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ment that the preferee have notice of the debtor's insolvency. *Id.* at 56. If so, this would strengthen the view, discussed at length below, that § 547(c)(2) only protects the unconscious preferee and, as such, in no significant way encourages dealings with insolvents. *See infra* notes 106-11 and accompanying text. Of equal significance is the indication in the report of the Bankruptcy Commission that the preference exceptions discussed in this article were created precisely because the transferees generally lack notice of the debtor's insolvency. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. 170 (1976) [hereinafter cited as REPORT]. *See also* Young, *Preferences Under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 221, 228 (1980).

15. Bankruptcy Code § 547(c)(2), 11 U.S.C. § 547(c)(2) (Supp. V 1981). This section states that:

> (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 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. . . .

Id.

16. *Id.* § 547(c)(1). This section states that:

> (c) The trustee may not avoid under this section a transfer—
>
> (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 . . . .

Id.

17. *Id.* § 547(c)(4). This section states that:

> (c) The trustee may not avoid under this section a transfer—
>
> . . .
>
> (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 una-

Both individually and collectively, these exceptions fail to address realistically or effectively the problem of the trade creditor. The section 547(c)(1) exception is rarely available. The section 547(c)(4) exception can be of some use to creditors who have both the sophistication and the leverage to impose rather restrictive terms on the buyer. The section 547(c)(2) exception manages to be simultaneously complex, ambiguous, and excessively restrictive. Moreover, as will be discussed below, it may literally be impossible to utilize the section 547(c)(2) exception in preparing a workout plan.[18] It is quite possible that a "conscious" preferee, who has adjusted its terms of dealing with the debtor to protect itself against the debtor's possible demise, cannot use section 547(c)(2). Only the "unconscious" preferee, who does not know or does not care about the debtor's plight, will be protected. If this is the case, then this exception simply cannot provide any incentive to a trade creditor to deal with a debtor.[19] It would merely provide an after-the-fact refuge for payments which merely happen to fall within its rigid terms.

In short, section 547(c) does not, at present, solve the trade creditor problem. If it is, or should be, a policy of the Bankruptcy Code to encourage trade creditors to deal with failing businesses, a major revision of either the section 547(c) exceptions or the section 547(b) definition of a preference will be necessary. In the author's view, such a revision ought to have two primary goals. First, it should protect equality of distribution among creditors at least as well as current law does. Second, it should not unduly limit the ability of a creditor to use the exception consciously in preparing a workout plan with the debtor.

II. Statutory Exceptions to Voidable Preferences

A. *Contemporaneous Exchange Exception*

The first of the exceptions available to the trade creditor, while the simplest to apply, is usually of little assistance. Section

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voidable transfer to or for the benefit of such creditor . . . .

Id.

18. *See infra* notes 106-11 and accompanying text.

19. Actually, it is more precise to say that preference exceptions reduce the disincentive created by preference law. A seller deals with a buyer because it believes it will get paid. Preference law increases the risk that the seller will not be paid, thus reducing the seller's incentive. The preference exceptions do no more than lessen the increase in the seller's risk.

547(c)(1)[20] prevents the trustee from avoiding preferences that were intended to be contemporaneous exchanges and were, in fact, substantially contemporaneous. As such, it is only a modest extension of the requirement in section 547(b) that, to be voidable, the transfer must relate to an antecedent debt.[21] The paradigmatic case is payment by check.[22] A concurrent payment by check will not be voidable if the check is not dishonored.[23]

This exception works very well for the seller who does not utilize ordinary business terms. However, it does nothing for those sellers who are often most valuable to the struggling buyer—those who continue to sell to it on open account. A business that can afford to make immediate payment by check for all of its purchases is unlikely to go bankrupt. A financially-strapped business needs its thirty, sixty, or ninety days of unsecured, open account credit more than ever. Of course, the purpose of section 547(c)(1) is not to protect those who advance credit. However, its presence in the Code emphasizes the paradox inherent in the section 547(c) exceptions. The seller who advances credit increases the chances of the buyer's survival much more than the seller who does not. This, in turn, increases the chance that all creditors will be paid. However, the seller who advances credit is far less protected by section 547(c) than the non-credit seller who, while certainly providing value to the estate, can constitute a critical and potentially fatal drain on the dwindling liquid assets of the failing business debtor.[24]

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20. Bankruptcy Code § 547(c)(1), 11 U.S.C. § 547(c)(1) (Supp. V 1981). *See supra* note 16.

21. Bankruptcy Code § 547(b)(2), 11 U.S.C. § 547(b)(2).

22. H.R. REP. No. 595, 95th Cong., 2d Sess. 373, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6329 [hereinafter cited as H.R. REP. No. 595]; S. REP. No. 989, *supra* note 14; 124 CONG. REC. S17, 414, H11, 1097 (1978).

23. 124 CONG. REC. S17, 414, H11, 1097 (1978). What if the transferee does not promptly initiate collection of the check? Section 547(c)(1) should not apply. The transaction was not intended to be contemporaneous; rather, it was a means of extending credit "secured" by the creditor's possession of the check. The House and Senate reports, however, seem to require only that the check be presented for payment within 30 days. H.R. REP. No. 595, *supra* note 22; S. REP. No. 989, *supra* note 14. These remarks manage to misstate the presentment rules of U.C.C. § 3-503(2)(a) (1977). That section imposes a requirement of presentment within a reasonable time and creates a presumption that for an uncertified United States check "reasonable" means presentment or initiation of bank collection within 30 days of date or issue, whichever is later. The reports treat this as a requirement of presentment within 30 days of an unspecified date. In any event, they do not deal with whether the retention of a check constitutes an extension of credit.

24. This result may merely be reflective of one assumption apparently underlying preference law—that insolvency is more immediately threatening to the debtor's survival (and the creditors' interests) than illiquidity. The Code's treatment of this entire issue is a trifle

B. *Subsequent Advances Exception*

Section 547(c)(4)[25] is a revision of section 60c of the Bankruptcy Act[26] and can be best described as a subsequent advance rule. If the creditor has received a preference, but has made one or more new advances of credit to the debtor subsequent to the preference, the amount of the preference may be reduced by the amount of the new advance. This reduction occurs only if the new advance was unsecured and remained unpaid or, if secured or paid, the security interest or payment was itself avoided.[27]

It should be noted that this section has been repeatedly confused with the so-called net result rule.[28] It is not the net result rule and indeed bears only a distant family resemblance.[29] The net

schizoid—insolvency is a prerequisite for avoidance of a preferential transfer (*see supra* notes 4 & 10) but not for the initiation of a bankruptcy proceeding. Virtually any individual or entity may file a voluntary petition. Bankruptcy Code §§ 109, 301, 11 U.S.C. §§ 109, 301 (Supp. V 1981). An involuntary case may be commenced against almost any individual or entity who "is generally not paying [its] . . . debts as such debts become due. . . ." *Id.* § 303(h)(1). It is not clear why certain types of interests should merit the Code's protection upon illiquidity and others only upon insolvency.

25. *Id.* § 547(c)(4); *see supra* note 17.

26. *See, e.g.*, Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 187 (1979).

27. Bankruptcy Code § 547(c)(4), 11 U.S.C. § 547(c)(4) (Supp. V 1981).

28. For example, the legislative history refers to § 547(c)(4) as a codification of "the net result rule in section 60c of current law." H.R. REP. No. 595, *supra* note 22. *See also* S. REP. No. 989, *supra* note 14. As section 60c was already a "codification" and was neither "the" nor even "a" net result rule, this is an extremely amusing statement.

29. Although the House and Senate reports are not explicit in distinguishing § 547(c)(4) from the net result rule, the Report of the Bankruptcy Commission states:

> The Commission's recommendation does not, however, go as far as the "net result rule" established by some early cases. A true "net result" rule would total all payments and all advances and offset the one against the other. This is not allowed under the Commission's recommendation, since the advance to be offset must be subsequent to the preference.

REPORT, *supra* note 14, at 210-11.

Historically, the net result rule arose because of an anomoly in the 1898 Bankruptcy Act. Under Bankruptcy Act § 60b, 11 U.S.C. § 60b (1976) (repealed), preferences were voidable only if the transferee had, at the time of the transfer, reasonable grounds to believe that the transferor was insolvent. However, in 1901 the then-current version of § 57g of the Act was interpreted to require that a creditor turn over all preferences received as a prerequisite to the allowance of any claim against the estate. Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901). Consequently, creditors wishing to establish claims were forced to disgorge even those preferences which were not avoidable by the trustee. The original net result rule was a response to this absurdity. *See In re* Thomas W. Garland, Inc., 19 Bankr. 920, 922-24 (Bankr. E.D. Mo. 1982). The rule was developed in three Supreme Court cases: Joseph Wild & Co. v. Provident Life & Trust Co., 214 U.S. 292 (1909); Yaple v. Dahl-Millakan Grocery Co., 193 U.S. 526 (1904); and Jaquith v. Alden, 189 U.S. 78 (1903). Under the *Jaquith-*

result rule was a common law doctrine, technically obsolete since 1903. It occasionally crops up in cases and literature since then[30] but probably does not survive, in any form, the enactment of the Code.[31]

Yaple-Wild rule, the net effect of all advances of credit to and transfers from the debtor occurring *after* the first preferential transfers from the estate served to reduce the preference. In other words, unlike § 547(c)(4) of the Code (and unlike § 60c of the Act—*see, e.g.*, *In re* Ira Haupt & Co., 304 F. Supp. 917 (S.D.N.Y. 1969)), once a preferential transfer had occurred, the sequence of subsequent advances and preferences was irrelevant.

The *Jaquith-Yaple-Wild* rule applied only if the transferee did not have reasonable grounds to believe that the debtor was insolvent. Consequently, it only protected the transferee of a non-voidable preference. Therefore, when § 57g of the Act was amended in 1903 to require that only voidable preferences be surrendered (Bankruptcy Act, ch. 487, § 12(g), 32 Stat. 799 (1903)), the *Jaquith-Yaple-Wild* rule became obsolete. In spite of this, the ghost of the net result rule has from time to time haunted the courts. A fairly modern example is *In re* Stewart, 233 F. Supp. 89 (D. Or. 1964), a case particularly apropos to this article. In *Stewart*, a supplier of gasoline agreed with an economically troubled buyer to make additional shipments of gasoline only if the debtor paid the second most recent invoice prior to the receipt of each shipment. The court held the payments received under the agreement non-preferential, in part relying on what it called the net result rule. *Id.* at 92-93. More significant, perhaps, was the court's additional finding that the payments were not for antecedent debts but, in fact, an exchange for the new advances of credit. It should be noted that *Stewart* and other "modern" net result rule cases do not require that the transferee lack notice of the transferor's insolvency, for the obvious reason that the imposition of such a requirement would now make the rule meaningless. *See, e.g.*, *In re* Fulghum Constr. Corp., 14 Bankr. 293, 305-06 (Bankr. M.D. Tenn. 1981), *aff'd*, 706 F.2d 171 (6th Cir. 1983). These cases are thus not applying the *Jaquith-Yaple-Wild* rule, but a new net result rule of ill-defined scope.

30. *See, e.g.*, *In re* Stewart, 233 F. Supp. 89 (D. Or. 1964).

31. *In re* Wadsworth Bldg. Components, Inc., 711 F.2d 122, 123-24 (9th Cir. 1983); *In re* Fulghum Constr. Corp., 706 F.2d 171 (6th Cir. 1983) *aff'g* 14 Bankr. 293 (Bankr. M.D. Tenn. 1981). *See also In re* Saco Local Dev. Corp., 30 Bankr. 859, 861 (Bankr. D. Me. 1983); *In re* Rustia, 20 Bankr. 131, 135-36 (Bankr. S.D.N.Y. 1982); *In re* Thomas W. Garland, Inc., 19 Bankr. 920, 925-26 (Bankr. E.D. Mo. 1982); *In re* Bishop, 17 Bankr. 180, 183-85 (Bankr. N.D. Ga. 1982); *but see In re* Fulghum Constr. Corp., 14 Bankr. 293, 303-08 (Bankr. M.D. Tenn. 1981). In *Fulghum*, 706 F.2d 171, the court distinguished the subsequent advance rule created by § 547(c)(4) from the net result rule. The court correctly held the subsequent advance rule to be part of a "calculated legislative scheme" to "implement [the] equitable considerations which the judiciary at the turn of this century adjudged as lacking and responded by evolving the net result rule." 706 F.2d at 174. The court failed to fully trace the evolution of the net result rule or its long obsolescence. Moreover, it failed to note the presence of what is probably a "true" net result rule in § 547(c)(5). *See infra* note 34. These points, of course, only strengthen the court's position. The *Jaquith-Yaple-Wild* rule, unlike § 547(c)(4), only very indirectly and almost accidentally aided the running account creditor, whose real protection from the trustee was the requirement that a preferee have reasonable cause to believe the transferor was insolvent. *See, e.g.*, Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148, 1165-72 (1981). When Congress chose to create a net result rule for the floating lienor, it did so explicitly in § 547(c)(5). *See infra* note 34. Finally, were a new common-law net result rule to be created, it is not clear what would be left of § 547(c)(4). If such a rule were a "pure" net result rule, the statutory exemption would have no function whatsoever. *In re* Thomas W. Garland, 19

The section 547(c)(4) exception can, obviously, be of greater utility than the section 547(c)(1) exception. It encompasses many aspects of a typical series of open account transactions. Because that type of business relationship assumes an ongoing sequence of sales and payments, it is not at all unusual for at least some part of a preference received as part of the relationship to be offset by a later advance of credit. For example, assume that the seller advances credit to the buyer on May 15, May 29, June 11, and July 4. The seller receives preferential transfers from the buyer on May 10, June 16, and July 7. The May 10 preferential transfer can be reduced by the amounts of all the subsequent advances. The June 16 preferential transfer can be reduced by the amount of the July 4 advance. However, the July 7 preference cannot be reduced at all—none of the advances were subsequent to it.[32] This creates an odd quirk in the rule. The availability of the section 547(c)(4) exception rests on the timing of the transfers and the advances, not on the economic impact on the estate of the series of transactions. Two sets of transactions with exactly the same economic effect are treated differently, due merely to a fortuity of dates. In theory, the estate is not diminished by a preference if there is a subsequent advance. Thus, one oft-stated policy underlying preferences, that of equality of distribution, is vindicated. However, if the estate is diminished on May 1 by preference and augmented on May 2 by an advance of credit, it is no larger than it would have been had the augmentation occurred on May 1 and the diminution on May 2.[33] Even more curious is that, when dealing with secured

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Bankr. 920, 929 (Bankr. E.D. Mo. 1982). If it were to incorporate a standard of good faith or lack of notice of insolvency (thus modeling itself on *Jaquith-Yaple-Wild*), it would in effect reintroduce the very notice requirement explicitly rejected by the Code. It may be desirable to put the notice of insolvency requirement back in the Code. However, it is difficult to justify doing so by judicial means.

32. *See In re* Wadsworth Bldg. Components, Inc., 711 F.2d 122, 123 (9th Cir. 1983).

33. On the other hand, preference law has also evidenced concern about the dismantling of the debtor's assets during the period immediately prior to bankruptcy. *See generally* 4 J. Collier on Bankruptcy ¶ 547.03 (L. King 15th ed. 1983). This policy could, in theory at least, justify § 547(c)(4)'s sequence rule. After all, if a pure net result rule were adopted, a creditor who made its last advance on the 90th day before the petition could spend the next 89 days dismantling the debtor as vigorously as possible. Section 547(c)(4) may to some degree deter such behavior, while a net result rule would not.

However, the purported policy against dismantling the estate is so weakly effectuated by the Code that the possible deterrent effect would be negligible. The notion appears to be that the threat of subsequent avoidance by the trustee will dissuade the transferee from seeking, or obtaining, a preference. This, in turn, will preserve the estate for the benefit of all creditors.

creditors holding a floating lien on inventory or receivables, Congress avoided this anomaly by creating what appears to be a true net result or net effect rule in section 547(c)(5).[34] Why this distinction was drawn is not a mystery,[35] yet its logical justification remains elusive.

Because of this distinction, an attorney counseling a nervous

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It is sufficient to note, however, that there is no penalty other than the possible costs of litigation and uncertainty for receiving a preference. *See, e.g.*, McCoid, *Bankruptcy, Preferences and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 264-68 (1981). Consequently, the risk of avoidance creates no significant deterrent to preferees. Thus, the alleged policy of avoiding dismemberment of the debtor, while possibly having some existence in the dreams of bankruptcy lawyers, has little or no real existence in the Code.

Moreover, it is unlikely that changing § 547(c)(4) to a net result rule would reduce a trade creditor's willingness to sell to a debtor. At present, the exception provides no incentive to deal, because a creditor cannot better its position. The subsequent advances must remain unpaid for the exceptions to be available. Thus, the seller's incentive comes not from the Code, but from its evaluation of the business risks and benefits involved. The only way § 547(c)(4) can affect this decision is in structuring the method of payment. But under either § 547(c)(4) or a net result rule, the seller would never worsen its position if it merely decided not to sell at all. The seller's incentive to sell will consequently not be affected by dropping the sequence requirement.

34. Bankruptcy Code § 547(c)(5), 11 U.S.C. § 547(c)(5) (Supp. V 1981). This section states that:

> (c) The trustee may not avoid under this section a transfer—
>
> . . .
>
> (5) of 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 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; and
>
> (B) the date on which new value was first given under the security agreement creating such security interest. . . .

Id.

It should be noted that Professor Duncan apparently does not view § 547(c)(5) as a "pure" net result rule. Duncan, *Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978*, 36 ARK. L. REV. 1, 25-29 (1982).

35. The provision appears to have been a legislative response to lobbying by financial institutions dismayed by the bankruptcy judge's decision, later reversed, in *In re* Portland Newspaper Publishing, Inc., 2 BANKR. L. REP. (CCH) ¶ 61,722 (Bankr. D. Or. 1966), *rev'd*, 271 F. Supp. 395 (D. Or. 1967), *aff'd sub nom.* Dubay v. Williams, 417 F.2d 1277 (9th Cir. 1969). *See* Countryman, *Bankruptcy Preferences—Current Law and Proposed Changes*, 11 U.C.C. L.J. 95, 103 (1978).

seller should advise the client to structure any workout plan so that every payment for a past sale is received before any further sale is made.[36] Therefore, section 547(c)(4) can be consciously used only by creditors who know that the debtor is in serious financial trouble, who have the sophistication to consult attorneys with the sophistication to know how section 547(c)(4) works, and who have the bargaining power to force the debtor to accept a rigid and somewhat cumbersome workout plan. The creditor may not have that knowledge or that leverage, or the buyer may not be able to make payments in accordance with the section 547(c)(4) rules. If the policy is indeed to encourage trade creditors to deal with buyers, it would be far more logical to create a rule that is simple, readily available to all buyers, and sufficiently flexible to permit the parties to negotiate a workable arrangement within the structure of the bankruptcy preferences. Section 547(c)(4) fails on all these counts.

An additional problem presently exists because the Code does not adequately define the date on which a transfer or an advance occurs. Obviously, because the availability of the section 547(c)(4) exception depends upon the timing, rather than the effect, of transfers and advances, two critical issues must be addressed. When did the transfer occur? When was the new extension of credit made? The smart trustee may attempt to date the advance as early as possible and the transfer as late as possible.[37] The clever seller, on the other hand, may try to do just the opposite. While there are obviously many factual issues that will have to be resolved in each case, a more fundamental question is the legal standard to be applied. The Code, in this respect, is not especially helpful. Most of the case law has arisen in litigation over the section 547(c)(2) exception. This section contains what seems to be substantially identical provisions regarding the timing of transfers and advances, although in a somewhat different context. Because

36. As will be discussed below, it may be necessary to obtain final payment on the debtor's check prior to the subsequent advance of credit. *See infra* text accompanying notes 95-104. As it is at least possible that the advance will be held to have occurred as early as identification to the contract (*see infra* notes 49-90 and accompanying text), this may be quite difficult. The buyer may simply be unable to wait.

37. Obviously, this will decrease the size of the § 547(c)(4) setoff and thus increase the size of the preference. However, it should be noted that any attempt to juggle dates must be done with an eye on § 547(c)(2), under which the trustee will wish to stretch the gap between the incurrence of an obligation and its payment by a preferential transfer. Attorneys for both sides are well advised to carefully analyze the potential cumulative effect of all the preference exceptions before taking a position on any of them.

of this, these issues will be more fully explored below.

C. *Ordinary Course Exception*

As is implied in the preceding discussion, the section 547(c)(2)[38] exception (often called the "forty-five day rule") is potentially the most useful to trade creditors. It has sparked much, if not most, of the reported litigation concerning the bankruptcy exceptions. The forerunner of the forty-five day rule was the current expense rule,[39] a poorly defined judicial exception to the preference rules of section 60 of the Bankruptcy Act.[40] Certain types of ordinary course payments made by the debtor during the preference period, although technically within the language of section 60, were not treated as preferences by some courts. The paradigm was the payment of general operational expenses during the preference period.[41]

Of much greater significance to the ordinary course transferee under the Act, was the requirement under section 60b that, for a preference to be voidable, the preferee had to have reasonable cause to believe that the transferor was insolvent.[42] Many ordinary course transferees did not have reason to believe that their transferor was insolvent. Consequently, the payments they received were not preferences.[43] With the abolition of the "reasonable cause to believe" requirement, it became necessary either to devise a more workable exception for ordinary course transferees or to treat all ordinary course transferees as preferees, with the concomitant danger that sellers would thus be discouraged from dealing with marginal, but still financially salvable, buyers.

Unfortunately, the device selected is both complex and, in several key respects, seriously deficient. Its complexity makes it difficult to use in structuring a workout, and its deficiencies may make it futile to try. Indeed, the very fact that the debtor has agreed to a workout may make section 547(c)(2) unavailable to the creditor.[44]

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38. Bankruptcy Code § 547(c)(2), 11 U.S.C. § 547(c)(2) (Supp. V 1981). *See supra* note 15.

39. *See, e.g.*, Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 201-02 (1980).

40. Bankruptcy Act § 60, 11 U.S.C. § 60 (1976) (repealed).

41. Kaye, *supra* note 39, at 202.

42. Bankruptcy Act § 60b, 11 U.S.C. § 60b (1976) (repealed).

43. *See, e.g.*, Fortgang & King, *supra* note 31, at 1165-72.

44. *See infra* notes 106-11 and accompanying text.

Under the section 547(c)(2) exception, a preference is not avoidable if four conditions are met. First, the transfer must be made in payment of a debt incurred in the ordinary course of business or financial affairs of both the debtor and the creditor. Second, the transfer must be made no later than forty-five days after the debt was incurred. Third, the transfer itself must be in the ordinary course of business or financial affairs of both the debtor and the creditor. Last, the transfer must be made according to ordinary business terms.[45] Because this article is concerned only with the effect of section 547(c) on routine business transactions with trade creditors, the first requirement will not be discussed further. However, the second requirement will be discussed in detail and followed by an examination of the third requirement in conjunction with the fourth.[46] These requirements pose very difficult questions of interpretation and use for the trade creditor. When is a debt "incurred"? When is a transfer "made"?[47] What is a transfer in ordinary course of business? What are ordinary business terms? Each of these interpretive questions will be discussed below. Overriding all of these, however, is the fundamental difficulty with section 547(c)(2)—its limitation to transactions completed within forty-five days. Even if the problems of incurrence, transfer, ordinary course of business, and ordinary business terms are resolved in a manner that would make the rule workable, the restriction to forty-five days has the effect of excluding from the operation of the provision many perfectly legitimate ordinary course credit transactions.[48]

1. When Is a Debt "Incurred"?

Since the section 547(c)(2) exception, like the section 547(c)(4) exception, hinges upon the timing of the parties' transactions, it is necessary, in evaluating its applicability, first to determine the day from which the forty-five day period is measured. The Code provides remarkably little guidance. Although section 547(a)(4) de-

45. Bankruptcy Code § 547(c)(2), 11 U.S.C. § 547(c)(2) (Supp. V 1981).

46. This is because most of the analyses of the effect of changes in credit or payment terms upon the availability of the exception have dealt with such changes under the ordinary course of business rubric. *See infra* note 107. This issue is more properly dealt with under the ordinary-business-terms requirement.

47. As noted, these same issues arise in a different context in analyzing § 547(c)(4). *See supra* note 37 and accompanying text.

48. *See, e.g.*, Fortgang & King, *supra* note 31, at 1167-70.

fines with some precision the date on which a tax liability arises,[49] there is no such provision for any other type of obligation. The term "debt" is defined by section 101(11) as "liability on a claim".[50] "Claim" is further defined as any right to payment "liquidated, unliquidated, fixed, contingent, matured, unmatured . . . ."[51] Neither of these definitions detract much from the initial ambiguity. A variety of rules have been proposed to pinpoint the elusive date, but as yet no firm guideline has emerged. A shibboleth, that a debt is incurred when "the obligation to pay becomes legally binding," has won widespread acceptance.[52] The phrase is unobjectionable, but adds nothing to the analysis. As will be discussed below, in many commercial sales contracts there are a number of dates when *an* obligation is created. The real issue is *which* obligation triggers the running of the section 547(c)(2) time period.

With reference to sales transactions, the possible dates include, at least, the date of the underlying contract;[53] the date goods are identified to the contract;[54] the date of shipment;[55] the date of de-

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49. Bankruptcy Code § 547(a)(4), 11 U.S.C. § 547(a)(4) (Supp. V 1981). This section states that "a debt for a tax is incurred on the day when such tax is last payable, including any extension, without penalty." *Id.*

50. *Id.* § 101(11).

51. *Id.* § 101(4). This section states that:

> (4) "claim" means—
>
> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured . . . .

Id.

52. *E.g., In re* Iowa Premium Serv. Co., 695 F.2d 1109 (8th Cir. 1982); *In re* Emerald Oil, 694 F.2d 88 (5th Cir. 1982); Barash v. Public Fin. Corp., 658 F.2d 504, 511 (7th Cir. 1981); *In re* Valles Mechanical Indus., Inc., 20 Bankr. 350, 352-53 (Bankr. N.D. Ga. 1982); *In re* Ray W. Dickey & Sons, Inc., 11 Bankr. 146, 147 (Bankr. N.D. Tex. 1980); *In re* McCormick, 5 Bankr. 726, 731 (Bankr. N.D. Ohio 1980).

53. Kaye, *supra* note 39, at 204 (the date of the underlying contract was mentioned but rejected). This date may have been adopted by the court in *In re* Balducci Oil Co., 33 Bankr. 843, 846 (Bankr. D. Colo. 1983).

54. This suggestion seems to have originated with a statement in 4 J. COLLIER ON BANKRUPTCY ¶ 547.38, at 547-121, that:

> The probably better view is that the debt is incurred whenever the debtor obtains a property interest in the consideration exchanged giving rise to the debt. Thus if goods are identified for shipment, unless the special agreement otherwise provides, the debtor has a special property interest and the debt is "incurred". Certainly when a debtor uses a utility the debt is incurred at the time the resource is consumed rather

livery;[56] the date the bill is rendered;[57] or the date payment is due.[58] Curiously, few courts or commentators have related the dates selected to the law of contracts or sales. This has tended to augment the confusion inherent in the problem itself. In any contract that is executory for an appreciable period of time, there will be several points at which obligations, related but dissimilar, will arise.

For example, assume that, on June 1, Seller enters into a contract with Buyer to sell 1,000 widgets, to be delivered on August 1. On June 1, both parties have one type of obligation—the obliga-

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> than when the invoice is sent. Thus in the above example, unless the utility bill is sent and paid within a short time, there is a significant probability that payment of the utility bill will be made more than 45 days after the debt is incurred.

Id.

A number of courts have purported to adopt this rule. *E.g.*, *In re* Iowa Premium Serv. Co., 695 F.2d 1109 (8th Cir. 1982); Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981); *In re* Brown, 20 Bankr. 554 (Bankr. S.D.N.Y. 1982); *In re* Valles Mechanical Indus., Inc., 20 Bankr. 350 (Bankr. N.D. Ga. 1982); *In re* Ray W. Dickey & Sons, Inc., 11 Bankr. 146 (Bankr. N.D. Tex. 1980); *In re* McCormick, 5 Bankr. 726 (Bankr. N.D. Ohio 1980). However, none of the cited cases deal directly with the question here addressed. Only three—*Barash*, *Brown*, and *McCormick*—dealt with sales of goods. *Barash* and *McCormick* dealt with installment payments for consumer goods and held, unexceptionably, that the debt paid by each installment was incurred at the time of the original purchase. *Brown* ruled that the debt paid for under a credit card account was incurred upon purchase, not remittance of the bill. In such cases, the COLLIER rule would have little impact on the availability or usefulness of § 547(c)(2).

55. Apparently the earliest statement of this rule was in Levin, *supra* note 26, at 186-87: "Congress has not defined when a debt is incurred. . . . For the purpose of this exception, the debt is incurred when it becomes a legally binding obligation on the debtor. Thus when goods are shipped, the debtor becomes liable for the payment, and the debt is incurred."

As Mr. Levin was a member of the House Judiciary Committee Staff which drafted the Code, his view has been widely cited by courts. *E.g.*, *In re* Caro Prods., Inc., 23 Bankr. 245, 249 (E.D. Mich. 1982); *In re* Hensman, 20 Bankr. 569, 575 (Bankr. N.D. Ohio 1982); *In re* Donny, 11 Bankr. 451, 452 (Bankr. W.D. Wis. 1981); *In re* Bowen, 3 Bankr. 617, 618-19 (Bankr. E.D. Tenn. 1980); *see also In re* Richter & Phillips Jewelers & Distribs., 31 Bankr. 512, 515 (Bankr. S.D. Ohio 1983). However, the degree to which this view has actually been adopted by the courts is uncertain. The *Caro Products* case, for example, can be read as supporting the COLLIER rule, the *Levin* rule, or the tender of delivery and acceptance rules discussed *infra* notes 60-61 and accompanying text. Since the result in the case would not be affected by the adoption of any one of these four incompatible rules, the court was not required to make any selection among them.

56. *In re* Bagwell, 29 Bankr. 461 (Bankr. D. Or. 1983). However, the court is unclear whether it means delivery or tender of delivery, which are not the same. *See also In re* Saco Local Dev. Corp., 30 Bankr. 859, 861 (Bankr. D. Me. 1983).

57. This date was noted and rejected by a number of courts. *See infra* note 89 and accompanying text.

58. Kaye, *supra* note 39, at 204-05. This has been generally rejected by the courts. *See infra* note 89 and accompanying text.

tion to perform the contract. In the language of Article Two of the Uniform Commercial Code, Seller, at that time, is obligated to "transfer and deliver"[59] conforming goods to the buyer.[60] Buyer, in return, is obligated to accept and pay for the goods at the contract price.[61] Moreover, neither party may impair the other's expectation of due performance.[62] It is obvious that an obligation exists on June 1. It is equally obvious that the obligation is a "debt" under section 101(11) of the Bankruptcy Code. The real issue is whether this is the debt with which section 547(c)(2) is, or should be, concerned.

When the goods are identified to the contract—specifically, when Seller selects the actual widgets it will send to Buyer—the legal relationship of the parties changes slightly. Buyer now has both an insurable[63] and a property[64] interest in the goods, and can be subject to certain damage remedies.[65] Moreover, under limited

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59. "The obligation of the seller is to transfer and deliver . . . ." U.C.C. § 2-301 (1977).

60. "Tender of delivery requires that the seller put and hold conforming goods at the buyer's disposition . . . ." *Id.* § 2-503(1).

61. "The obligation of the . . . buyer is to accept and pay in accordance with the contract." *Id.* § 2-301.

62. "A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired." *Id.* § 2-609(1).

63. *Id.* § 2-501(1).

64. *Id.* This, of course, is the rationale for the COLLIER rule (*see supra* note 54) that the debt is incurred in a sale of goods upon identification to the contract.

65. This is only in part an explicit requirement for recovery but is implicit in at least some of the seller's primary damage remedies, which as a practical matter require some identification of the goods to be sold. For example, the seller is permitted to resell "the goods" and sue for any shortfall in the amount received on resale. U.C.C. § 2-706 (1977). Obviously, this cannot be determined unless the seller can state *which* goods are resold. Moreover, the seller's specific performance remedy, an action for the price, explicitly requires identification of the goods. *Id.* § 2-709(1)(b). (See also the risk of loss rules which require identification to the contract. *Id.* §§ 2-509, -510.) Therefore, if it has not already done so, the seller will be able to identify goods to the contract *after* the buyer's breach. *Id.* § 2-704(1)(a). This right of post-breach identification could create a very anomalous situation if the COLLIER rule (*see supra* note 54) were adopted. It is at least arguable that a breaching buyer who settled the seller's claim within 45 days of the seller's identification of the goods would be protected by Bankruptcy Code § 547(c)(2), even though the settlement might not occur until months or years after the breach. (Of course, such a transaction could be held not to comply with the requirement of § 547(c)(2) that the transfer be in the ordinary course of business. On the other hand, all businesses have contract claims against them from time to time and some quite frequently. Such claims are routinely settled by most companies. To hold that a good faith settlement of a legitimate claim arising from day-to-day operations is not in the ordinary course of business is a bit strained.)

An additional question arises if the identified goods are non-conforming. Under U.C.C. § 2-501(1), the property interest arises, but the buyer has no legal obligation to accept or pay for such goods prior to acceptance. *Id.* § 2-607. Even if the COLLIER rule were to be adopted, circumstances, Buyer can now obtain possession of the goods.[66] The legal relationship changes again upon Seller's tender of delivery. Assuming that the goods are conforming, tender will usually terminate Seller's non-warranty obligations under the contract[67] and shift the risk of loss to Buyer.[68] If Buyer then accepts the tendered goods, it will incur a further obligation to pay at the contract price,[69] subject to his right to set off any claim for breach of warranty or contract.[70]

Any of these dates could rationally be selected as the date the debt was "incurred." Upon each a legally binding obligation arose. Yet, the date chosen will profoundly effect the usefulness of section 547(c)(2) to the trade creditor. If, for example, the date of the contract is held to be the date the debt was incurred, then few trade creditors will be able to use the forty-five day rule.[71] Generally, there will be a substantial gap between the contract and shipment and a further gap between shipment and receipt. If any significant credit period is permitted to the buyer,[72] the chance of

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an exception for non-conforming goods should, at least arguably, be created. This, however, might conceivably discourage the trustee from pursuing important contract claims for fear that success might jeopardize subsequent recovery of a preference. It could even encourage trade creditors to allege that the goods they shipped to the buyer were non-conforming (presumably the claimed non-conformity would be slight, so as to avoid a significant counterclaim for damages from the estate). There is thus no sufficient reason to create such an exception. It would have no impact on the creditor's decision to deal with the debtor but would greatly increase the cost of some preference litigation.

66. U.C.C. § 2-711(2)(a) (1977). Upon non-delivery or repudiation, if the goods have been identified, the buyer can recover. *Id.* § 2-502.

67. This is implicit in the requirement that the seller "transfer and deliver," *id.* § 2-301, and in the tender requirement that the seller "put and hold conforming goods at the buyer's disposition," *id.* § 2-503(1).

68. *Id.* § 2-509. Assuming that the contract is a "shipment" contract, under which the goods are transferred by carrier and the buyer pays the freight, the risk of loss passes to the buyer upon due delivery to the carrier. *Id.* § 2-509(a). Such due delivery of conforming goods also constitutes tender. *Id.* §§ 2-504, -503(2).

69. *Id.* § 2-607(1).

70. *Id.* §§ 2-714, -717.

71. In many commercial sales contracts an oral contract is made over the telephone and confirmed by subsequent written communications. *See, e.g.*, J. White & R. Summers, Uniform Commercial Code § 1-2, at 24 (2d ed. 1980). The written confirmations are necessary if the contract is for $500 or more to comply with the Statute of Frauds. U.C.C. § 2-201 (1977). Thus, it could be argued that, even if the date of contract were the proper date for commencing the 45 day rule, the date of the written confirmation, not the oral contract, should be used. Until then, there is no legally binding obligation (unless, of course, an exception to the Statute of Frauds applies, *e.g.*, specially manufactured goods, *id.* § 2-201(3)(a)).

72. According to one commentator, Congress selected the 45 day period on the assumption that the ordinary credit terms offered by open account sellers required payment by the

completing the transaction within the necessary period is slight. There is also a technical objection to this approach. Section 547(c)(2) refers to the date "the" debt was incurred. The obligation created by mere contract formation is not, ordinarily, the debt paid by the preferential transfer.[73] The obligations of the buyer that exist upon the date of the contract could enable the seller to prevail in a suit against the buyer for breach of contract.[74] However, only rarely can the contract price be recovered in a contract action.[75]

The key issue, of course, is whether the purpose of section 547(c)(2) will be frustrated. If the exception is really designed to encourage (or at least not discourage) sellers to sell to failing buyers, an interpretation that would make the rule available only in exceptional cases is absurd. It is, of course, axiomatic that statutes ought to be interpreted in such a way as to effectuate, not frustrate, their perceived purposes.[76]

A number of courts have, at least in dicta, embraced the "identi-

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15th day of the month following the month of shipment. Levin, *supra* note 26, at 186-87. The source of this assumption is unknown. Such anecdotal evidence, as is available, suggests that the credit terms most often stated are 30 or 60 days from the date of invoicing. *See, e.g.*, Fortgang & King, *supra* note 31, at 1167-70. Moreover, those stated terms are not always strictly enforced; an additional 30, or even 60 day period is often permitted without protest. This additional time period may well become part of the contract as a course of dealing or usage of trade under U.C.C. § 1-205 or a course of performance under § 2-208. If this is the case, the selection of 45 days, measured from the date of shipment (which has no necessary relationship to the date of invoicing), means that Bankruptcy Code § 547(c)(2) at best can provide only slight help to the trade creditor. If the measuring date is pushed back still further, as by adoption of the COLLIER (*see supra* note 54) or the *Levin* (*see supra* note 55) rule, the scope of this exception will be even slighter.

73. Usually, of course, the transferor will be paying all or some part of the contract *price*, and this obligation is not ordinarily created until acceptance. *See supra* notes 68-69 and accompanying text.

74. Ordinarily, the mere formation of the contract only requires that the buyer not impair the seller's expectation of due performance. U.C.C. § 2-609 (1977). The formation also subjects the buyer to the obligation to accept and pay for the goods upon the concurrent condition of transfer and delivery by the seller. *Id.* §§ 2-301, -507. Failure to meet these obligations gives the seller the right to utilize various damage remedies; however, these remedies are usually measured by the seller's loss and not by the price of the goods. *Id.* § 2-703. For example, if the seller, pursuant to § 2-706, resells the goods for $2,000 less than their contract price, the seller can recover only $2,000 (plus incidental damages under § 2-710), and *not* the contract price. The debtor did not pay the $2,000, but the entire price of the goods. Thus, "the" obligation created by contract formation was not "the" obligation paid.

75. Generally, the seller can sue for the price only if the goods were accepted, were lost or damaged after the risk of loss passed to the buyer, or cannot be resold within a reasonable time at a reasonable price. *Id.* § 2-709.

76. Of course, it is by no means clear that this is the purpose of the exception. *See supra* note 14.

fication to the contract" rule which was apparently first proposed in *Collier on Bankruptcy*.[77] If this becomes the prevailing interpretation of section 547(c)(2), many trade creditors will be entirely unprotected by the exception. For example, a seller who specially manufactures goods for the buyer may identify them to the contract long before shipment. Even a seller who identifies to the contract at the time of shipment will be hard pressed to obtain payment within forty-five days if only thirty days credit is extended.

If the "identification to the contract" rule is accepted, the technical objection noted above would also apply. "The" debt paid by the preferential transfer will ordinarily be the contract price. Even if the buyer breaches after identification to the contract, only rarely will the buyer be liable for the contract price.[78] Finally, identification to the contract is of only tangential significance in creating obligations. Its primary function is to provide the buyer with both an insurable and a property interest in the goods, and the seller with a means of measuring damages.[79] It does not, by itself, create any additional liability.

The date of shipment rule is, from a technical standpoint, the most difficult to defend. While the shipment does not create "the" debt, it also creates no obligation and has no direct relationship to the buyer's obligations. Shipment, as opposed to tender of delivery, is in and of itself relatively insignificant under Article Two of the Uniform Commercial Code. In business contracts, tender of delivery often occurs upon shipment, but this is by no means always the case.[80] In non-business contracts, frequently there will be no shipment, and therefore tender of delivery will usually occur either when the goods are delivered to the buyer or when the seller makes the goods available to the buyer.[81] However, if the unfortunate choice of the word "shipment" is ignored, or replaced with the phrase "tender of delivery," the rule would be a significant ad-

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77. 4 J. Collier, *supra* note 54. See also notes 64-65.

78. *See supra* note 75.

79. *See supra* notes 63-65 and accompanying text.

80. The Uniform Commercial Code presumes that most sales contracts involving shipment by carrier are "shipment" contracts. U.C.C. § 2-503 comment 5 (1977). In other words, usually the buyer will pay the freight and the seller's non-warranty obligations will be fulfilled upon due delivery of conforming goods to a carrier. *See supra* notes 67-68. Consequently, in most such caes, tender of delivery and shipment will occur at the same, or substantially the same, time. However, if the contract is a destination contract, tender of delivery requires tender of delivery to the buyer, not merely delivery to the carrier. U.C.C. § 2-503(3) (1977). In that case, the tender will occur long after shipment.

81. U.C.C. § 2-503(1) (1977).

vance on those discussed above. In some contracts, although by no means all, it would be at least possible to squeeze an ordinary thirty day credit period into a forty-five day interval between tender and payment. Section 547(c)(2) would still be of little assistance to the seller whose goods required a significant period of time to transport to the buyer or extensive inspection after delivery.[82]

The most justifiable date from a purely Article Two perspective is the date of acceptance. Usually, a buyer is obligated to pay for goods at the contract price only after acceptance,[83] which normally follows inspection.[84] As noted above, the contract price is "the" debt being paid by the preferential transfer. More significantly, this date meshes section 547(c)(2) rather well with the actual mechanics of a sale. Usually, the buyer does not wish to incur an obligation to pay for goods before inspection because it does not know if the goods conform to the contract. Since this is part of the ordinary process of the purchase, the courts, in interpreting a provision theoretically designed to protect ordinary course transfers, should arguably read it as permitting, to the extent possible under the statute's wording, the parties to proceed in ordinary course without risk of incurring preference liability.

On the other hand, there are substantial objections to defining this date as the date on which the debt is incurred. First, although it may mesh well with what the buyer does, it does not particularly correspond with credit terms. The credit period granted by a seller ordinarily runs from either the date of invoice or the date of tender. What legislative history there is suggests that the statute is designed to correspond with what its drafters perceived to be the normal credit period, not the time it would take to complete the entire transaction.[85] Second, the date of acceptance can be very difficult to pinpoint because acceptance can occur in a number of ways, including mere inaction.[86] Consequently, the use of this date could serve to greatly increase the difficulty and expense of preference litigation. Moreover, this increased expense would, in most

82. The same considerations apply to the delivery rule of *In re* Bagwell, 29 Bankr. 461 (Bankr. D. Or. 1983), in which the court may in fact have meant tender of delivery, not delivery. *See supra* note 56.

83. U.C.C. §§ 2-607(1), -709 (1977).

84. Ordinarily, the buyer has the right to inspect the goods prior to acceptance. *Id.* § 2-513.

85. *See supra* note 72.

86. U.C.C. § 2-606 (1977).

cases, serve little purpose, since the date of acceptance will usually not be much later than the date of tender of delivery. Since the date of tender of delivery in a commercial sale contract is usually relatively easy to determine[87] and provides at least some chance for the trade creditor to obtain payment within forty-five days, it is the most appropriate day from which to measure the date the debt was incurred at least insofar as trade creditors are concerned.[88]

The last two proposed rules cited, which would tie the date the debt was incurred to the rendering or due date of a bill, have been generally rejected by the courts,[89] and correctly so. If preference law accomplishes anything—and that it does is an article of faith in the bankruptcy system—an exception that would permit certain creditors virtually to immunize themselves from preference liability would not be desirable. By conscious and clever manipulation of the date a bill was rendered or due, a creditor might bring almost any transfer within the forty-five day rule.

To date, it has not generally been necessary for the courts to pinpoint the date the debt was incurred because, in most cases, the

87. It will usually be the date of shipment or delivery. *See supra* note 80.

88. There is arguably at least one significant exception to this general statement. If the goods tendered are non-conforming, the buyer has no obligation to pay for them until acceptance. *See supra* note 65. As that note indicates, however, the inclusion of such an exception in either the COLLIER, the *Levin*, or the "tender of delivery" rule would unduly increase the complexity of the preference litigation. While it does some violence to the concept that the debt is incurred when the debtor becomes legally obligated to pay, efficiency dictates that whichever rule is adopted, few, if any, exceptions of this nature should be allowed.

89. *E.g., In re* Emerald Oil, 695 F.2d 833 (5th Cir. 1983); *In re* Valles Mechanical Indus., Inc., 20 Bankr. 350 (Bankr. N.D. Ga. 1982); *In re* Ray W. Dickey & Sons, Inc., 11 Bankr. 146 (Bankr. N.D. Tex. 1980). There are at least two cases which can be construed as supporting the opposite view. *In re* Thomas W. Garland, Inc., 19 Bankr. 920 (Bankr. E.D. Mo. 1982); *In re* Mindy's, Inc., 17 Bankr. 177 (Bankr. S.D. Ohio 1982).

Each case, however, can be readily distinguished. *Mindy's* involved payments on a lease measured as a percentage of sales. The court noted that because of this method of payment the amount owed for any given month could not be measured prior to the end of the month. Therefore, it measured the 45 days from the end, rather than the beginning of the month. 17 Bankr. at 180. As a practical matter, since the rent obligation did not arise until the end of the month (there would have been no obligation had there been no sales), the case is not inconsistent with those cited above. *Garland*, which involved payment for utility services, correctly noted that it was impossible to measure the date during any given service month upon which any given kilowatt of power was consumed. 19 Bankr at 927. Thus, for practical reasons, the court held that the debt was incurred at the end of the service period. *Id.* Although this deviated slightly from the general rule, it did so only to accommodate a normal business practice which by no stretch of the imagination significantly involved the underlying policies of preference law.

time lapse under any rule was substantially more than forty-five days.[90] This reflects the most fundamental weakness of the rule. Quite simply, there are many ordinary course transfers it does not protect at all.

2. When Is a Transfer "Made"?

Of equal importance in measuring the forty-five day period under the section 547(c)(2) exception is the determination of when the transfer was made. Since, in general, the transfer will be made by check, there are at least three dates which could be chosen—the date the check was delivered to the seller,[91] the date the seller initiated the process of bank collection,[92] and the date of final payment.[93] Once again, the drafters of the Code have not burdened us with much guidance. There is one quotation in the legislative history which appears to be relevant: "[P]ayment 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 § 547(c)(1) and (2)."[94] On the surface, this supports the first of the three indicated dates. As indicated,[95] it ties in well with one provision of Article Three of the Uniform Commercial Code, namely section 3-802, which suspends the un-

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90. *See, e.g., In re* Caro Prods., Inc., 23 Bankr. 245 (Bankr. E.D. Mich. 1982). In this case, 81 days lapsed between the date of the contract and the last shipment. Thus, the payment probably occurred more than 45 days after acceptance and, even under that rule, would not have been protected under § 547(c)(2) of the Bankruptcy Code. *See also In re* Valles Mechanical Indus., Inc., 20 Bankr. 350 (Bankr. N.D. Ga. 1982). The contract in this case required payment on or after April 14, 1981 for services performed no later than February 27, 1981. Again, the court's "adoption" of the COLLIER rule (*see supra* note 54) did not affect the outcome of the case.

91. When a negotiable instrument to which a bank is not a party is "taken" for an obligation, that obligation is suspended until its due date or, if payable on demand, until presentment. U.C.C. § 3-802(1)(b) (1977). Obviously, this suspension could be viewed as the date the transfer was made.

92. The significance of this date is not related to the UNIFORM COMMERCIAL CODE but to the fact that it is not uncommon for a seller to agree to hold a check sent to it by a troubled buyer for a specified period of time. This constitutes a further extension of credit. *See supra* note 23.

93. Final payment of a check generally terminates the ability of creditors of the drawer to garnish, attach or obtain an assignment of the funds paid from the drawer's account. U.C.C. § 4-303(1) (1977). Conversely, prior to final payment, the funds can be assigned, attached or garnished, regardless of the fact that checks drawn on the account have been issued by the drawer. *See generally* J. WHITE & R. SUMMERS, *supra* note 71, § 17-7, at 692-703.

94. 124 CONG. REC. S17, 414, H11, 1097 (1978).

95. *See supra* note 91.

derlying obligation upon the taking of a negotiable instrument.[96] Moreover, the selection of the date of delivery serves to make the narrow limits of the forty-five day rule at least somewhat workable. If the date of final payment is used, it will be very difficult for a seller to obtain payment within the required time period. It is not unusual for five to ten days to be expended in the process of collection and final payment.

It is, however, equally true that under both Article Three of the Uniform Commercial Code and the common law, the mere delivery of a negotiable instrument is not payment.[97] Nor is it in all respects a transfer. While the creditor may have the right to use the funds credited to its account as soon as the check is deposited, the debtor is not, merely by the act of issuing the check, deprived of equivalent funds in its own account. A check is not an assignment of funds but merely a "conditional payment"[98]—a direction to the drawee to pay.[99] In less technical terms, until final payment is made, the drawer-debtor can withdraw the money from its account or stop payment, and a creditor can garnish or attach.[100] While that would cause the check to be dishonored and permit the holder to sue the drawer,[101] it does not give the holder any automatic right to any specific property of the debtor. In short, the estate has not actually been diminished until there is final payment.

Moreover, the Bankruptcy Code itself contains definitions of transfer in sections 101(40) and 547(e)(1)(B). The former defines a transfer as any "mode . . . [of] disposing of or parting with property . . . ."[102] The latter states that, for section 547 purposes, a transfer of personalty occurs "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."[103] Put simply, a transfer as defined by section 547(e)(1)(B) does not occur until final payment.[104]

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96. U.C.C. § 3-802 (1977).

97. U.C.C. § 3-409(1) (1977); J. WHITE & R. SUMMERS, *supra* note 71, § 17-7, at 692-703.

98. *Id.*; U.C.C. § 3-802 comment 3 (1977).

99. Thus, the liability of the drawer of a draft is ordinarily conditioned upon presentment to, and dishonor by, the drawee. U.C.C. § 3-413(2) (1977).

100. *Id.* § 4-303.

101. *Id.* §§ 3-507, -412(2).

102. Bankruptcy Code § 101(40), 11 U.S.C. § 101(40) (Supp. V 1981).

103. *Id.* § 547(e)(1)(B).

104. *See supra* notes 93-100 and accompanying text; *see also* Henson, *The Uniform Commercial Code and the New Bankruptcy Act: Some Problem Areas*, 35 BUS. LAW. 83, 95-96 (1979).

There is, finally, an additional pitfall in a literal reading of the statement in the legislative history. It is not at all uncommon for a creditor to agree to hold, for a stated period of time, a check sent by a debtor. If a check is delivered on June 1 but, pursuant to agreement, held by the creditor until June 10, the question arises whether the transfer actually occurred on June 1 or June 10. It seems more logical to say that the transfer occurred no earlier than June 10. If this limitation were not read into the date-of-delivery rule, it would allow obvious manipulation of the forty-five day rule by debtors and creditors.

Just as the date of tender of delivery seems the most acceptable compromise of technical and practical considerations in determining the date the debt was incurred, the date of delivery of a check to the seller, if properly limited, is also the best selection for the date the transfer was made. To wait for the date of final payment would squeeze unacceptably the already narrow parameters of section 547(c)(2). The scarce case law can be read to reject the statement of the legislative history.[105] However, while it may not have much Article Three logic on its side, it does breathe some life into the forty-five day rule. As noted, however, the date of delivery of the check should be the date of transfer only if there is a prompt initiation of bank collection, and if the check is ultimately honored by the drawee.

3. Ordinary Course of Business and Ordinary Business Terms

It is perhaps the underlying thesis of this article that the trade creditor who, as its buyer drifts towards bankruptcy, enters into an accommodation with the buyer under which the buyer will reduce preexisting obligations in exchange for the creditor's permission to

105. Several Code cases have held that the date of presentment is the date of transfer, although in a slightly different context. *In re* Bob Grissett Golf Shoppes, Inc., 34 Bankr. 320, 322 (Bankr. E.D. Va. 1983); *In re* Brent Explorations, Inc., 31 Bankr. 745 (Bankr. D. Colo. 1983); *In re* Sportsco, Inc., 12 Bankr. 34 (Bankr. D. Ariz. 1981); *In re* Duffy, 3 Bankr. 263 (Bankr. S.D.N.Y. 1980). All of these cases were concerned with whether the transfer had occurred during the preference period. These can perhaps be distinguished because the policy reasons underlying § 547(c)(2) favor the adoption of the rule proposed by the House and Senate reports. *See supra* note 14. The position taken by these cases has been cited by the 5th Circuit with apparent approval. *In re* Emerald Oil Co., 695 F.2d 833, 836 n.4 (5th Cir. 1983) (dicta). At least two 45 day rule cases have held that the transfer is not made until the check is honored. *In re* Super Mkt. Distribs. Corp., 25 Bankr. 63, 65 (Bankr. D. Mass. 1982); *In re* Mindy's, Inc., 17 Bankr. 177, 179 (Bankr. S.D. Ohio 1982). *Contra In re* Thomas W. Garland, Inc., 19 Bankr. 920, 928 (Bankr. E.D. Mo. 1982).

incur new ones, deserves significant protection from the dangers of preference liability. It is upon these creditors that the faltering buyer's slender chances of survival rest. In dealing with the buyer's failing business, the creditor will, if it can, wish to obtain some protection so that its own situation does not worsen through a gradual increase in unpaid receivables. In doing so, however, the seller may paradoxically become disqualified for the benefits of section 547(c)(2).

The third and fourth requirements of the forty-five day rule are that the transfer be made in the ordinary course of business and according to ordinary business terms.[106] These are the most opaque requirements to date. What do they mean? Nearly any workout agreement will entail some changes in the credit terms offered by the seller. These changes may involve a reduction in the credit period, a requirement that a set percentage of "stale debt" be paid in addition to current payments, or a change in the method of allocating prior payments. Indeed, many creditors, if they are to fit under section 547(c)(2) at all, will have to change credit terms. For example, sellers who have previously allowed sixty-day credit will have to reduce the period. Moreover, against what standard are the credit terms to be measured? Do the phrases ordinary course of business and ordinary business terms encompass only an "objective" standard based on industry practice? Or do they include a subjective standard based on the parties' prior contract and course of dealing?

There has been much more concern about this issue in the commentaries than in the cases.[107] The problem is, nevertheless real. If

106. Bankruptcy Code § 547(c)(2)(C)-(D), 11 U.C.C. § 547(c)(2)(C)-(D) (Supp. V 1981). *See supra* note 15.

107. The following articles have at least discussed the issue. Countryman, *supra* note 35, at 102; Fortgang & King, *supra* note 31, at 1168-70; Queenan, *The Preference Provisions of the Pending Bankruptcy Law*, 82 COM. L.J. 465, 474-75 (1977); Tait &Williams, *supra* note 14, at 63-66. To date, little of the case law has explored the issue in any depth. In *In re* Williams, 5 Bankr. 706 (Bankr. S.D. Ohio 1980), the debtor, an obligor of Sears, Roebuck & Co., had been paying about $28.00 per month on account for a fence and other items he had purchased. During the last few months before his bankruptcy, the debtor for unknown reasons sharply increased the amount paid to Sears. The court held that these payments were not in ordinary course and thus did not meet the requirements of § 547(c)(2). *Id.* at 707. If taken at face value, this would mean that even a preferee who had made no effort to press collection would lose the beneift of § 547(c)(2) whenever its debtor decided, for whatever reason, to make a change in its manner of payment favorable to the creditor. *See also In re* Craig Oil Co., 31 Bankr. 402 (Bankr. M. D. Ga. 1983) (change in method of payment from corporate check to cashier's check meant that payment was not in ordinany course of business or pursuant to ordinary business terms).

the courts read the ordinary-course and ordinary-business-terms requirements restrictively, section 547(c)(2) may become, at least as far as many trade creditors are concerned, an amusing but rather useless appendage to the Code.

On the other hand, it can be argued that the requirements of ordinary course and ordinary business terms are fundamental to the whole concept of a preference. Preference law is designed to prevent creditors from obtaining a better position than other creditors. That is, of course, precisely what the seller is trying to accomplish in a workout. If a seller dealing with an insolvent does not obtain preferential transfers, then the workout has been a largely useless act.[108] Why then should the bankruptcy courts be concerned with the inability of creditors to utilize the preference exception of section 547(c)(2) where such creditors are consciously seeking preferences?[109]

Although unconscious preferees have arguably been hurt by the elimination of section 60b's reasonable-cause-to-believe-insolvency requirement in favor of the section 547(c) exceptions, such is not

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The legislative history offers little guidance. There is, however, at least one statement in the House and Senate reports which strongly supports the view that any significant change in the seller's terms will preclude the applicability of § 547(c)(2): "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, *supra* note 22; S. REP. No. 989, *supra* note 14.

Arguably, a workout agreement, which the buyer and seller have entered into solely because of the "debtor's slide into bankruptcy," is exactly the type of "unusual action" Congress did not intend to be protected by § 547(c)(2).

108. If the debtor is solvent, the creditor of course has not received a preferential transfer. If, on the other hand, the debtor is insolvent, the creditor, in receiving transfers, is in large part attempting to obtain a larger than pro rata payment from the debtor's limited assets. This of course comes at the expense of other creditors, who are the presumed beneficiaries of preference law. But what if the overall effect of the creditor's dealings with the debtor is to reduce the degree to which the debtor's obligations exceed its assets? It is arguable that a workout agreement which includes provision for continued sales to the debtor has such a beneficial effect. After all, such sales may help keep the debtor in business and, if the business is profitable, the estate will be increased and perhaps even become solvent.

109. It has been suggested that the ordinary-course and ordinary-business-terms requirement is, in fact, reflective of the same policy which underlay the old reasonable cause to believe insolvent requirement. *See, e.g.*, Queenan, *supra* note 107, at 474; Young, *supra* note 14, at 228. However, this is not entirely true. It seems clear that § 547(c)(2) is available even to a creditor who knows of the debtor's insolvency, so long as it does not act on its knowledge. To this extent, even the conscious but passive preferee will be protected. Conversely, if the extraordinarily narrow *Williams* rule, discussed *supra* note 107, is accepted, even the unconscious preferee who has benefited from an unsolicited unilateral change in the debtor's payment habits may be unable to preserve the transfer.

the case with the conscious preferee. Generally speaking, any preferee who enters into a workout with a failing buyer has cause to believe, if not actual knowledge of, the debtor's insolvency. Consequently, those who are not protected under section 547(c)(2) would not have been protected under section 60 either.

The difficulty with this line of reasoning is that it ignores the purported purpose of section 547(c)(2). There is simply no point in creating a preference exception to encourage an unconscious preferee to deal with a faltering business. By definition, that preferee does not know the business is in substantial trouble and, consequently, will not know enough to stop selling.[110] The only people who need encouragement to deal with the troubled buyer are those who know the buyer is troubled. Thus, if it is desirable to accomplish this goal, it is necessary to provide protection even for those who intend to obtain preferences. Section 547(c)(4) provides such protection,[111] but only in a very roundabout and cumbersome fashion. If the ordinary-course and ordinary-business-terms-requirements are read restrictively, section 547(c)(2) will provide the trade creditor with almost no useful protection whatsoever.

D. *Summary of Exceptions*

It is difficult to be entirely certain of the ultimate impact the section 547(c)(1), (2) and (4) exceptions will have on the trade creditor. However, it is clear that, even if read expansively, these exceptions will provide relatively little assistance for a trade creditor who is attempting to deal with a failing buyer. Section 547(c)(1) is essentially useless. Section 547(c)(4) can be useful, but only in limited circumstances and only for creditors who have the ability to utilize its rather indirect protection. Even under the

110. An argument can be made that the mere existence of the preference exception may create a general incentive for all sellers to continue to deal with failing buyers. However, this argument is weak for several reasons. First, the unconscious preferee is unlikely to know of § 547(c)(2)'s existence, much less its intricacies. Thus, there would be no incentive of even the most general kind. Second, the 45 day limit in § 547(c)(2) does not conform with ordinary business terms, and thus is unavailable to assist most trade creditors. *See supra* note 72. Of course, creditors in theory could change their credit terms to fit within § 547(c)(2). It is more than likely, however, that typical creditor terms exist because competition requires them. It is thus highly improbable that many creditors will have the bargaining power to force the buyer into credit terms acceptable to the drafters of the Code. Finally, the failing buyer often wants and needs something other than merely more of the same. It is far more likely to need a longer credit period than a shorter one. Section 547(c)(2) sharply reduces the flexibility needed to salvage a sinking buyer.

111. *See supra* notes 25-37 and accompanying text.

broadest reading, section 547(c)(2) suffers from the fatal forty-five day limitation. As has been indicated, many ordinary-course transfers involve much longer credit periods.[112]

In part, this may be due to the persistent tendency to view the receipt of a preference as somehow immoral. Thus, creditors who consciously attempt to receive preferences through workouts are not as protected as those who blindly stumble into them. The real question, however, should be whether it is desirable to encourage creditors to deal with failing businesses and, if so, whether a preference exception is a useful vehicle for doing so. Unfortunately, there is little but anecdotal evidence on either point.[113] In any event, there is little logic in providing more protection to those creditors who do not require any incentive to sell than is provided to those who do. The only rationale for such a result is that the unconscious preferee is somehow more virtuous, and thus ought to be protected. This is not an expression of logic or policy but merely of unanalyzed piety.[114]

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112. *See supra* note 72.

113. The underlying incentives for the seller to do business with a faltering buyer do not include the preference exceptions, which merely reduce the disincentive of preference law. *See supra* note 19. The seller wants to sell and, if the buyer's business is truly salvageable, the seller will want to keep it in operation to increase the chance of the seller eventually getting paid. It may well be that these underlying incentives far outweigh the possibility that some payments might eventually be avoided as preferences. If so, all of the exceptions are, insofar as the seller's decision to deal is concerned, entirely superfluous.

114. There are fundamental inconsistencies even in the pietistic approach. First, the Code does not penalize all creditors who "grab off" preferences, only those who are not quick enough. The creditor who, because of greater leverage, cynicism, or wit obtains a preferential transfer more than 90 days before the petition will, unless an insider, not be subject to a voidable preference ruling. Only the preferee who moved too slowly is penalized. Sloth may not be a virtue, but in this situation it is difficult to justify rewarding speed.

As a result, those who receive preferences may well be those who have continued to do business with the debtor up to the end. These creditors may have tried to keep the debtor afloat. Indeed, in so doing, they may even have enabled the debtor to make non-voidable preferential transfers to those creditors who stopped dealing with the debtor at an earlier date. The drafters of the Code may have believed that businesses fail in 90 days. That does not comport with the general experience. Business failures may stretch over many months or even years. The notion that creditors who have enabled the debtor to continue in business ought to be penalized while those who abandoned the debtor are left unpenalized is by no means self-evident.

In part, this error of analysis may stem from the assumption that the debtor's estate is an essentially static entity, diminished by transfers and augmented by advances. This may be true for consumers but it is not for businesses. The primary means of augmenting a business estate is the sale of goods or services. A preferential transfer which enables the business to obtain money or property, which in turn enables it to sell, can have a benefit to the estate far beyond the value of the money or property advanced. It is far more logical for preference

III. Suggestions for Reform

Assuming for present purposes that it is desirable to encourage trade creditors to deal with failing businesses, it is evident that substantial revisions must be made to section 547 to effectuate this policy. Further, assuming that preference law accomplishes anything useful (a fascinating topic beyond the scope of this article),[115] it is obviously necessary to reach some rational compromise between the goals of preference law and the provision of adequate incentives for sellers to sell.

The usual rationales for the law of preferences are to avoid dismemberment of the debtor and to ensure equality of distribution.[116] The first rationale is largely meaningless.[117] There are no penalties for obtaining a preference. Indeed, there are considerable benefits to the preferee. It is not unusual for preference litigation to occur many months or even years after the preference was received. In the interim, the creditor will have had the use of the money received. Moreover, much preference litigation is settled for less than the amount of the debt. However, if the purported policy against dismemberment is still dear to the heart of anyone, it can be effectuated by limiting the scope of preference laws to those creditors who received transfers from the debtor and did not make comparable advances to the debtor during the same period of time.

The second rationale, equality of distribution, is more complex although perhaps equally meaningless.[118] All trade creditors involved in workouts are seeking preferential transfers—more than they would receive if the debtor's assets were merely distributed pro rata among all creditors of the same class at the time of the transfer. However, under present law, those trade creditors who are lucky enough to receive their preferential transfers outside the bankruptcy preference period are not required to disgorge them.[119] Only those preferees who have continued to deal with the debtor

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law to concern itself with the actual effects on the estate, than with a mythical reduction of a mythical lump of unchanging assets.

115. *See, e.g.*, McCoid, *supra* note 33, at 262-68.

116. *See generally* 4 J. Collier on Bankruptcy ¶ 547.03 (L. King 15th ed. 1983).

117. *See supra* note 33.

118. The Code's policy of "equality" is tenuous at best. First, it is imposed only within classes of debt. Second, even within a class, those creditors who are preferred outside the preference period are allowed to retain their unequal distributions. This might be justifiable if the preference period in any way resembled the time it took a typical business to fail. This does not, however, seem to be the case.

119. *See supra* note 4.

are at risk. Only their unequal distributions are forfeited. Because of this and the fact that there is no penalty for receiving a preference, there are few, if any, reasons why a creditor should not attempt to receive a preferential transfer.[120] Since creditors are virtually encouraged to receive preferential transfers, it is ridiculous to penalize certain preferees on perceived morality grounds. If the preferee has continued to do business with the debtor (again, assuming that continuing to do so is desirable), there is no logical reason for penalizing a creditor who did not have his advances of credit and preferential transfers in the right order, as is done under section 547(c)(4),[121] or for treating a conscious preferee differently from an unconscious preferee, as is apparently done under section 547(c)(2).[122] Indeed, if we are to encourage trade creditors to sell, we must encourage those who are disinclined to sell—those who are conscious of the debtor's problem.

One method of addressing these issues is to abolish section 547(c)(2) and (c)(4), and replace them with the unified exception similar in substance to section 547(c)(5). As is apparently true in section 547(c)(5),[123] this new exception would permit the trustee to avoid preferential transfers only to the extent that the transfer improved the creditor's position (that is, to the extent that the total obligation of the debtor to the creditor was reduced). This would have several beneficial effects. First, it would eliminate the problems created by section 547(c)(4)'s sequence rule. Second, it would permit trade creditors to devise reasonable workout arrangements with troubled buyers, knowing that they would face preference liability for, at most, only a ninety day reduction in indebtedness. Third, unlike the rigid forty-five day rule, it would permit the trade creditor and its debtor to make flexible credit arrangements. The debtor's credit terms would not be squeezed to fit into the forty-five day rule. Fourth, it would, at least in theory, discourage creditors from attempting to dismantle a debtor by making more feasible a long term non-bankruptcy adjustment of debts.[124]

A less radical scheme has been proposed by Mr. Fortgang and

120. McCoid, *supra* note 33, at 262-68.

121. *See supra* notes 25-33 and accompanying text.

122. *See supra* notes 106-11 and accompanying text.

123. *But see* Duncan, *supra* note 34, at 25-29.

124. The preference period, at least for business bankruptcies, should also be lengthened to a period more nearly approximating the time it takes an insolvent business to fail. This would avoid the problems inherent in rewarding the very swift. *See supra* note 114.

Professor King in their brief but perceptive discussion of section 547(c)(2).[125] Their suggestion is to revive the requirement of reasonable cause to believe the debtor was insolvent. They correctly note that it was this requirement that saved most ordinary course transferees under the Bankruptcy Act.[126] Although simple and straightforward, this solution does not focus appropriately on the underlying purposes of protecting ordinary course transferees. It simply does not encourage them to deal with a troubled debtor because, once they know that the debtor is troubled, they may very well have reasonable cause to know the debtor is insolvent. Moreover, it does not adequately protect equality of distribution. Under their proposal, as under prior law, it would be perfectly possible for an ordinary course transferee (or even a non-ordinary course transferee) to receive payment in full during the preference period and not have to return the transfer to the estate. In short, section 60b of the Act only accidentally served to protect ordinary course transferees, and it did not do so in a manner which preserved the fundamental purpose of preference law. Merely to revive that rule makes sense only if a more direct approach is infeasible.

IV. Conclusion

Whatever their relative merits, there is little chance that these, or any proposals for reform will be adopted. Given the seeming inability of Congress to address far more critical bankruptcy problems,[127] it is unlikely that it will, in the near future, delve into so difficult and technical an issue as the section 547(c) preference exceptions. If this is the case, then the courts will be the forum for resolution of these problems. It will fall upon them either to interpret the section 547(c) exceptions broadly enough to provide some protection to trade creditors, or merely to abandon any systematic attempt to utilize them to facilitate ordinary course dealings with insolvent debtors.

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125. Fortgang & King, *supra* note 31, at 1167-71.

126. *Id.* at 1170-71.

127. *E.g.*, the complete failure of Congress to resolve the jurisdictional problems created by the Supreme Court's decision in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).