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MAGINOT LINE DEFENSES TO A PREFERENCE ACTION? 11 U.S.C. § 547(c)(2) & (c)(4)

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I. Introduction

Suppliers of goods and services on credit understand that the recipient may be unable to pay for some or all of the goods provided or the services rendered. However, many of these suppliers have a difficult time "giving back" money previously received from a debtor who has filed for protection under the United States Bankruptcy Code. Judicial interpretation of the broadly written bankruptcy law has made it difficult to defeat a preference action instituted by a trustee in bankruptcy or a debtor-in-possession. As a result, any supplier who has several transactions with a debtor during the preference period is particularly vulnerable.

A preferential payment, or preference, is a payment by the debtor which can be recovered and returned to the debtor's estate under the Bankruptcy Code.[1] The Code establishes that all creditors within the preference period[2] should be treated equally, as opposed to permitting the debtor to "prefer" one creditor over another.[3]

A preference is defined broadly and encompasses most payments

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1. The elements of a preference are:
    1. a transfer;
    2. to or for the benefit of a creditor;
    3. for or on account of an antecedent debt;
    4. made while the debtor was insolvent;
    5. made within the preference period (90 days before the petition was filed unless the creditor was an insider, in which case the preference period is one year);
    6. that enables such creditor to receive more than such creditor would receive in a liquidation if the payment had not been made.

11 U.S.C. § 547(b) (1982 & Supp. II 1984).

2. The preference period is variable. For non-insiders, the period is only 90 days. However, for insiders, the period is a full year. 11 U.S.C. § 547(b)(4)(A), (B) (1982 & Supp. II 1984).

3. The Code states that the "trustee may avoid any transfer of property of the debtor to or for the benefit of a creditor." 11 U.S.C. § 547(b) (1982).

made by the debtor during the preference period.[4] However, Congress recognized that many of these transfers should be allowed to stand. Accordingly, various defenses to preference actions were codified in the United States Code at subsection 547(c) of title 11.[5] This article will focus on two defenses to preference actions: (1) the "ordinary course of business" defense; and (2) the "subsequent advance" defense. Subsection 547(c)(2) was designed to protect suppliers in the ordinary course of business yet it has been interpreted to provide less protection than possible under the statute. Subsection 547(c)(4), "the subsequent advance rule," has been the subject of poorly reasoned and conflicting opinions that may substantially limit its usefulness. This article will be devoted to a discussion of these two subsections.

II. Subsection 547(c)(2)—The Ordinary Course of Business Defense

The elements of a (c)(2) defense are easily listed but difficult to interpret. The elements are: (1) the debt must be incurred by the debtor in the ordinary course of business of both the debtor and the transferees; (2) the payment or transfer must be made in the ordinary course of business of the debtor and the transferee; and (3) the payment must be made according to ordinary business terms.[6]

Prior to October 1984, the transfer also must have been made within forty-five days of the creation of the debt, but this limitation has been removed.[7] Many courts saw the forty-five day limit

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4. *See supra* note 1. This article will not extensively examine what constitutes a preference.

5. Generally, a creditor may successfully defend a preference action to the extent the preferential transfer was:

> 1. made in a contemporaneous exchange for new value given to the debtor;
> 2. made in the ordinary course of business;
> 3. given as a purchase money security interest;
> 4. made prior to the advancement of new, unsecured value by the creditor;
> 5. a perfected security interest in inventory or receivables, except to the extent that such a transfer places the creditor in a better position than he was in at the beginning of the preference period or at the time he gave new value, whichever was later;
> 6. the fixing of an unavoidable statutory lien; and
> 7. less than $600.00, in the case of an individual debtor.

11 U.S.C. § 547(c) (1982 & Supp. II 1984).

6. *Id.* § 547(c)(2) (Supp. II 1984).

7. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(b), 98 Stat. 333, 378 (1984) (deleting former 11 U.S.C. § 547(c)(2)(B)).

as a useful, objective benchmark of whether a debt was paid in the "ordinary course of business."[8] If the debt was paid within forty-five days of its creation, it was considered paid in the ordinary course of business.[9] The deletion of this forty-five day limit has forced courts to look to other criteria to determine whether payments were made in the ordinary course of business.

Predictably, courts have struggled to define the illusive concept of "the ordinary course of business" or even to establish objective criteria by which it may be measured. The concept is classically subjective,[10] and many courts refuse to create objective criteria simply to support a foregone conclusion. However, the following cases represent an attempt to create some framework of analysis.

In one of the most stringent applications of (c)(2) to date, the court in *Ewald Bros., Inc. v. Kraft, Inc.*,[11] held that payments made a few days after the established terms of payment were not made within the ordinary course of business. The creditor supplied raw milk to the debtor pursuant to a written agreement which provided that the debtor was to pay by the twenty-fifth of each month for milk delivered the first fifteen days of that month. Furthermore, the agreement provided that the debtor was to pay by the fifteenth of each month for milk delivered from and after the sixteenth day of the preceding month.[12] Prior to the period in question, the debtor had not been more than one or two days late on any payment.[13] The debtor attempted to pay for milk delivered in the second half of June by way of a check dated July 15. However, the check was returned due to insufficient funds, had to be redeposited, and did not clear the debtor's bank until July 24. The debtor paid for part of the milk purchased in the first half of July on August 1, seven days late, and paid the balance on August 6.[14]

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8. *In re* Hoover, 32 Bankr. 842, 849 (Bankr. W.D. Okla. 1983).

9. Butz v. Bancohio Nat'l Bank (*In re* Manns), 31 Bankr. 893, 896 (Bankr. S.D. Ohio 1983); *In re* Brown, 20 Bankr. 554, 555 (Bankr. S.D.N.Y. 1982).

10. Does "ordinary" mean ordinary to a healthy debtor, or one who is sliding into bankruptcy? Should a debtor with a cash flow problem honor its contractual obligations or seek to conserve its cash? These and other ambiguities create a highly subjective standard.

11. 45 Bankr. 52 (Bankr. D. Minn. 1984).

12. *Id.* at 54.

13. *Id.*

14. It is crucial to determine when the debt was incurred and when the transfer was made in discerning whether and to what extent any transfer was late. One view is that the transfer is deemed made when the creditor receives the debtor's check, at least if it clears the bank within 10 days. Gold Coast Seed Co. v. Spokane Seed Co. (*In re* Gold Coast Seed Co.), 30 Bankr. 551 (Bankr. 9th Cir. 1983); 124 CONG. REC. S17, 431 (daily ed. Oct. 6, 1978); 124

In evaluating the (c)(2) defense, the court decided that "ordinary" should be determined by what is historically ordinary between the respective parties.[15] Accordingly, all three payments were subject to avoidance since the court found that: (1) the payment made July 15 and honored July 24 was not ordinary because (a) the check bounced, and (b) the check was honored nine days late; (2) the payment made August 1 was not ordinary because (a) it was a split payment, and (b) it was made seven days late; and (3) the payment made August 6 was not ordinary because (a) it was a split payment, and (b) it was made twelve days late. Since there was no history of late or split payments in the parties' relationship, the payments were not ordinary and were subject to avoidance.[16]

While *Ewald Bros.* focused on the lateness of the payments, *Production Steel, Inc. v. Sumitomo Corp. of America*[17] held that payments made early were not made in the ordinary course of business. Sumitomo Corporation supplied steel to Production Steel, Inc., on four occasions, the fourth being within the preference period. Being aware of Production's deteriorating financial condition, Sumitomo demanded several new terms in the fourth transaction, including a deposit, security via a letter of credit, and payment before the original contractual due date.[18] The court determined that a payment was ordinary only if it was both normal between the parties and normal in the industry. Sumitomo failed both tests. The court found that the change in terms made the transaction extraordinary as between the parties and that Sumitomo had not presented any competent evidence of industry standards.[19]

Since sales involving the use of letters of credit are not uncom-

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CONG. REC. H11, 114 (daily ed. Sept. 28, 1978). Despite clear evidence of this legislative intent, some courts have reached a contrary result, holding that the transfer does not take place until the debtor's check is honored by his bank. Hartwig Poultry, Inc. v. C.W. Service (*In re* Hartwig Poultry), 57 Bankr. 236, 239 (Bankr. N.D. Ohio 1986). It is well established that the date the debt is created is the date on which the debtor becomes legally obligated to pay the debt. *Id.*

15. *Ewald Bros.*, 45 Bankr. at 57.

16. The court acknowledged that payments previously had been made one or two days late, *id.*, which would seem to be ordinary under the court's determination, but the court did not indicate at what day or hour the payment would become "extraordinarily" late. Presumably, if the debtor had had a less desirable credit record, e.g., various late payments or other cash flow problems that necessitated split payments, the court would have been forced to conclude that the payments were made in the ordinary course of business.

17. 54 Bankr. 417 (Bankr. M.D.S. Tenn. 1985).

18. *Id.* at 423.

19. *Id.* at 424. Sumitomo also had failed to demonstrate what the relevant "industry" was for the purpose of the case.

mon in international transactions, this case illustrates the problem with narrowly focusing on the relationship between the debtor and creditor. Any deviation from prior credit practices may enable the trustee successfully to attack a transaction that is acceptable to both the creditor and the debtor and likewise is an accepted practice in the marketplace.[20]

Working within a substantially different framework, the court in *Flatau v. Marathon Oil Co. (In re Craig Oil Co.)*[21] found that payments made for no valid business reason were not made in the ordinary course of business. Marathon Oil regularly supplied petroleum products to Craig Oil. On August 14, a Marathon representative was contacted by another petroleum vendor and asked to join an involuntary bankruptcy filing against Craig Oil. The Marathon representative contacted Craig Oil, relayed the conversation, and asked for evidence of Craig Oil's good faith.[22] From that point forward, Craig paid Marathon exclusively with cashier's checks. Craig purchased petroleum from Marathon for the final time on August 27, and subsequently paid its outstanding balance to Marathon via fourteen separate cashier's checks from August 27 through September 16.[23] While the court did not find that payment by "cashier's check [was] outside the scope of ordinary business practice in and of itself,"[24] the court did conclude that the payments were not made in the ordinary course of business. The court wondered why Craig sought to keep Marathon's good faith since it no longer needed Marathon's credit.[25] The court believed that Craig paid Marathon to insure that Marathon would not join in an involuntary bankruptcy filing.[26] Thus, the court concluded that the payments were not made for any type of ordinary business reasons.[27]

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20. With the benefit of hindsight, virtually any transaction with a troubled debtor may be characterized as "different" from prior transactions. It is difficult to imagine that many transactions would survive the scrutiny applied in *Production Steel.* As predicted in Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2), & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 694 (1983), "[i]f . . . read restrictively, section 547(c)(2) will provide the trade creditor with almost no useful protection whatsoever."

21. 31 Bankr. 402 (Bankr. M.D. Ga. 1983), *aff'd*, 785 F.2d 1563 (11th Cir. 1986).

22. *Id.* at 406.

23. *Id.* at 404.

24. *Id.* at 406.

25. *Id.* The record showed that Craig no longer needed to purchase petroleum from Marathon because Craig had no customers remaining in the area serviced by Marathon's petroleum terminal.

26. *Id.*

27. Extending the reasoning of this case one step further, it is arguable that no payment

In *Campbell v. Cannington (In re Economy Milling Co.)*,[28] the court adopted a broader definition of what constitutes the ordinary course of business. The creditor delivered 500 bushels of corn to the debtor in May pursuant to an option agreement whereby the debtor could return the corn without penalty at any time prior to July 19.[29] The corn was not returned to the creditor and the debtor paid $2,000 within forty-five days after July 19. In discussing whether the payment was made within the ordinary course of business, the court stated that the ordinary course requirement

> should usually be easy to meet. Since this showing is required merely to assure that neither the debtor nor the creditor do anything abnormal to gain an advantage over other creditors, an extensive showing that such transactions occurred often, or even regularly, is not necessary . . . . A transaction can be ordinary and still occur only occasionally.[30]

The court determined that the creditor had not made such a showing and held that the transfers were subject to avoidance. If the creditor had shown that the debtor previously had entered into similar option agreements with him or other creditors, then the payments would have been made in the ordinary course of business.[31]

Faced with facts similar to those in *Craig Oil*, the court in *Canfield v. Greensville Feed Mill of Emporia (In re Ferguson)*[32] reached a contrary result. The creditor regularly sold the debtor feed and other supplies for use in the operation of his pork farm. Payment was due by the fifth day of the month following billing. The debtor had a history of irregular late payments, usually in

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made by a debtor, who is short of cash, to a supplier, who is no longer needed by the debtor, is made within the ordinary course of business. In a perversion of normal business ethics, this case would find payments to creditors extraordinary unless the debtor needed further credit from that particular creditor.

28. 37 Bankr. 914 (D.S.C. 1983).

29. There was some dispute as to the exact nature of the agreement between the parties. The creditor testified that the agreement was for him to retain ownership of the corn until the debtor either paid for the corn or returned it to the creditor. However, the debtor testified that the corn had been purchased from the creditor on credit with payments to be made at some indeterminate time in the future. *Id.* at 916.

30. *Id.* at 922.

31. *Id.* This decision contrasts markedly from both *Ewald Bros.* (which focused on the lateness of payments made) and *Craig Oil* (which examined the reasons for tender of payment). *See supra* notes 11-16, 21-27 and accompanying text.

32. 41 Bankr. 118 (Bankr. E.D. Va. 1984).

multiples of $1,000, and never had paid the entire balance due.[33] However, on January 15, the debtor paid the entire balance due. On February 23, the debtor filed a bankruptcy petition. Despite the trustee's efforts, the court held that the January 15th payment could not be avoided because it was made in the ordinary course of business. The trustee argued that payment was significantly larger than prior payments, was in complete satisfaction of the balance due, and implicitly was outside the established payment period of the parties.[34] Nevertheless, the court noted that the prior practice of the parties was to maintain a running balance and found that since the debtor terminated its pork business it had good reason to make a final lump sum payment. Since the debtor had a valid business reason to make the unusual payment, it was made in the ordinary course of business.[35]

An analysis of the difference in facts between *Ewald Bros.* and *Ferguson* highlights the patent inequity of the former case.[36] In both instances, payments were made outside the terms agreed to by the parties. In *Ewald Bros.*, late payments, or at least payments later than one or two days, were unique, while in *Ferguson*, late payments were a matter of course. The only substantial difference in the cases, therefore, was the debtor's credit history.

These cases employ three distinct approaches for analysis of the ordinary course of business concept. The first approach is illustrated in *Ewald Bros.* and *Production Steel*, where the courts looked to the parties' relationship.[37] *Ewald Bros.* has received praise in some commentaries,[38] but legislative intent arguably is

33. *Id.* at 119.

34. *Id.* at 121.

35. *Id.*; *see also* Butz v. Champaign Landmark, Inc. (*In re* Butz), 33 Bankr. 926 (Bankr. S.D. Ohio 1983) (holding that the mere fact that payments had been made erratically over the course of dealings between the parties was insufficient to take the transaction outside the § 547(c)(2) exception).

36. Though the facts of the cases differ somewhat, it is likely that the decisions are as much a result of the difference in the biases of the judges as the differences in fact. This is to be expected when dealing with a subjective standard.

37. *See supra* notes 11-20 and accompanying text.

38. Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1) and 546(a)(1)*, 41 BUS. LAW. 175, 182-83 (1985). The author argues that in determining what constitutes the ordinary course of business "[t]he first basis for comparison should always be prior transactions between the parties." *Id.* at 186. However, to take such an approach invites conflicting opinions such as *Ewald Bros.* and *Ferguson*, since the analysis will always depend upon prior credit dealings between the parties. It makes more sense to determine what is ordinary in the industry in which the parties are dealing. This approach was adopted by the *Economy Milling* court, and promises to provide more nearly

not served by penalizing a creditor whose debtor had the "bad manners" to consistently pay in a timely fashion or rewarding a creditor for tolerating a debtor's continued sloppy credit practices.[39] Thus, this first standard is objectionable to be a dispositive standard because it fosters different results based solely upon the parties' prior credit dealings.

The second approach employed in analyzing the ordinary course of business concept is seen in *Craig Oil* and *Ferguson*, where the courts searched for a valid business reason for the payments.[40] This second standard is not particularly helpful because it simply restates the question, substituting "valid" for "ordinary."

The final approach, utilized in *Economy Milling*, focused on industry standards to determine what is "ordinary."[41] Regardless of prior dealings between the creditor and the debtor, if the transactions are within industry norms, they likewise should be considered "ordinary" for purposes of subsection 547(c)(2). This approach should lead to the most consistent, predictable results within the statutory framework, without doing violence to the expectations of creditors operating within the industry norms.

III. Subsection 547(c)(4)—The Subsequent Advance Rule

The "subsequent advance rule" states:

> (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 unavoidable transfer to or for the benefit of such creditor.[42]

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standard results. It is more likely that courts in different jurisdictions will reach similar results if their determinations do not depend upon past vagaries of the debtor or the lack thereof but rather upon industry standards taken as a whole.

39. Perhaps creditors should demand that their debtors annually skip at least one payment, make a partial payment and, most importantly, bounce a check. While this suggestion is made tongue in cheek, there certainly could have been a different outcome in *Ewald Bros.* if the credit history had been tarnished.

40. *See supra* notes 21-27, 32-35 and accompanying text.

41. *See supra* notes 28-31 and accompanying text.

42. 11 U.S.C. § 547(c)(4) (1982).

This section is the legislative response to the "net result rule," a judicially created exception to section 60 of the Bankruptcy Act. Under the net result rule, payments made to a creditor during the preference period were compared to goods or services supplied by him during the same period without regard to the sequence of events. If the creditor was paid more than he supplied, the difference was an avoidable transfer. If the creditor was paid less than he supplied, there was no avoidable transfer.[43] Despite some legislative history which suggests that (c)(4) was a codification of the net result rule,[44] courts now have rejected the net result rule in an attempt to interpret and apply the statutory formula.

Since the extension of new value (hereinafter subsequent advance) must occur after the preferential transfer, the first consideration in the (c)(4) defense is to determine when the preferential transfer and the subsequent advance were made. The subsequent advance is deemed to have been made when the debtor becomes legally obligated to pay for the goods or services.[45] The courts have split on how to determine the date of the preferential transfer that is made by check. There are two views: (1) that the transfer is made when the check is received,[46] at least if the check is honored within ten days;[47] and (2) that the transfer is made when the check is honored by the payor's bank.[48]

If the policy of (c)(4) is "to encourage trade creditors to continue dealing with troubled businesses,"[49] the first view seems more reasonable. However, an Ohio bankruptcy court recently has held that the second view is proper, i.e., that the date of transfer for pur-

43. For a thoughtful discussion of the net result rule and its demise, see Garland v. Union Elec. Co. (*In re* Thomas W. Garland, Inc.), 19 Bankr. 920 (Bankr. E.D. Mo. 1982).

44. S. REP. 989, 95th Cong. 2d Sess. 88, *reprinted in* 1978 U. S. CODE CONG. & ADMIN. NEWS 5787, 5874.

45. *See* Production Steel, Inc. v. Sumitomo Corp. of America (*In re* Production Steel, Inc.), 54 Bankr. 417 (Bankr. M.D.S. Tenn. 1985); Campbell v. Cannington (*In re* Economy Milling Co.), 37 Bankr. 914 (Bankr. D.S.C. 1983); Richter & Phillips Jewelers & Distribs., Inc. v. Dolly Toy Co. (*In re* Richter & Phillips Jewelers & Distribs. Inc.), 31 Bankr. 512 (Bankr. S.D. Ohio 1983).

46. Gold Coast Seed Co. v. Spokane Seed Co., 30 Bankr. 551 (Bankr. 9th Cir. 1983); Rovzar v. Biddeford & Saco Bus Garage, Inc. (*In re* Saco Local Dev. Corp.), 25 Bankr. 876 (Bankr. D. Me. 1982).

47. Ray v. Gulf Oil Prods., (*In re* Blanton Smith Corp.), 37 Bankr. 303 (Bankr. M.D. Tenn. 1984).

48. Hartwig Poultry, Inc. v. C.W. Serv. (*In re* Hartwig Poultry, Inc.), 57 Bankr. 236 (Bankr. N.D. Ohio 1986); Weinberg v. Mertz Corp. (*In re* Staveco Elec. Constr., Inc.), 48 Bankr. 247 (D.N.J. 1985).

49. *Gold Coast Seed*, 30 Bankr. at 553.

poses of subsections 547(c)(2) and (c)(4) is the date that the debtor's check clears its bank.[50] That court relied upon Ohio Revised Code section 1303.45 (U.C.C. section 3-409) and reasoned that the debtor did not lose dominion over its funds until payment by its bank.[51] While this approach may be appealing technically, it effectively penalizes a trusting creditor, thereby promoting an articifical debtor-creditor relationship, instead of the normal business relationship that should be fostered.

In order to receive protection from (c)(4), the creditor must have supplied "new value" to the debtor.[52] Thus, the second element in the (c)(4) defense requires an evaluation of the new value supplied. This extension of new value must be documented, and cannot be of speculative value.[53]

The third consideration in the (c)(4) defense denies the defense to the extent that an otherwise unavoidable security interest was granted on account of the subsequent transfer.[54] While this provision has not been discussed at length in cases or literature, its thrust is obvious: if the creditor is given an adequate security interest at the time of his subsequent advance, the subsequent advance should not be used to offset a prior preference. The bankruptcy courts have not dealt with a subsequent advance followed by the granting of an inadequate or avoidable security interest; however, the proper resolution may be to offset the prior preference by the subsequent advance less amounts received by virtue of the security interest.[55] For example, if the creditor received a preference of $3.00, extended new value in the amount of $2.00, and on account of the extension received a security interst in the amount of $1.00, he arguably should be entitled to use $1.00 of the new value as an offset against the preference.

The final element of (c)(4) has generated the most controversy and confusion. The defense is not available to a creditor who extends new value to the extent the debtor makes an otherwise unavoidable transfer to the creditor on account of the subsequent

50. *Hartwig Poultry*, 57 Bankr. at 236.

51. *Id.* at 239.

52. 11 U.S.C. § 547(c)(4) (1982).

53. Young & Peter J. Saker, Inc. (*In re* Paula Saker & Co.), 53 Bankr. 630 (Bankr. S.D.N.Y. 1985).

54. 11 U.S.C. § 547(c)(4)(A) (1982).

55. 4 COLLIER ON BANKRUPTCY ¶ 547.40 (L. King 15th ed. 1986).

advance.[56]

If payment was never received for the new value, and the other elements are met, there is an offset under (c)(4). If the debtor pays for the new value, but the payment is subject to avoidance, the result should be the same as nonpayment.[57] However, many courts have held that subsequent advances must remain unpaid to constitute offsets under (c)(4).[58] Other courts specifically have considered and rejected the requirement that subsequent advances remain unpaid.[59] An analysis of (c)(4) indicates that neither view is completely correct.

In *Pettigrew v. Trust Co. Bank (In re Bishop)*,[60] the court addressed a preferential payment followed by three extensions of credit, after which the debtor made partial repayments of the interim extensions of credit. The creditor moved for summary judgment, alleging that the interim extensions of credit should be offset against the first preferential payment even though they were repaid. The court refused to grant the motion and stated that one of the elements of the (c)(4) defense is that the subsequent advance must remain unpaid.[61] However, the court purposely declined to consider whether the final two payments were subject to avoidance by the trustee, or whether such an avoidance would be relevant to its decision.[62] Since *Bishop* was decided before *Ewald Bros.*, the trustee probably did not challenge the later partial repayments as being subject to avoidance, even though the argument certainly would exist under current law. Since the repayments were not challenged as avoidable, the court reached the correct result, albeit with an incomplete analysis.

While the *Bishop* dicta has been reiterated by many courts,[63] it also has been rejected by other courts. The court in *Young v. Peter*

56. 11 U.S.C. § 547(c)(4)(B) (1982).

57. Herbert, *supra* note 20, at 674.

58. *See Hartwig Poultry*, 57 Bankr. 236; Pettigrew v. Trust Co. Bank (*In re* Bishop), 17 Bankr. 180 (Bankr. N.D. Ga. 1982).

59. *See Paula Saker & Co.*, 53 Bankr. 630.

60. 17 Bankr. 180 (Bankr. N.D. Ga. 1982).

61. *Id.* at 183.

62. *Id.*

63. Erman v. Armco, Inc. (*In re* Formed Tubes, Inc.) 46 Bankr. 645, 646 (Bankr. E.D. Mich. 1985); Keydata Corp. v. Boston Edison Co. (*In re* Keydata Corp.), 37 Bankr. 324, 328 (Bankr. Mass. 1983); Rouzar v. Prime Leather Finishes (*In re* Saco Local Dev. Corp.), 30 Bankr. 859, 861 (Bankr. D. Me. 1983).

J. Saker, Inc. (In re Paula Saker & Co.),[64] dealt with the familiar pattern of several preferential transfers interspersed with several subsequent advances of new credit. The court considered the *Bishop* language, yet held that there was no statutory basis for placing such a limitation on (c)(4).[65] The court, in a correct application of the statute's policy, was concerned exclusively with replenishment of the estate, and determined that actual receipt of payment was not dispositive.[66]

This controversy had little practical siginificance prior to *Ewald Bros.* since payments that were not extraordinarily late were protected under (c)(2). If payments were extraordinarily late, the creditor most likely had ceased doing business with the debtor. Under current law, however, payments made a few days late are quite possibly subject to avoidance, but still acceptable to the supplier, who continues to make shipments based upon the "acceptably" late payments. When the supplier subsequently loses under the (c)(2) defense, he is stuck with subsequent advances that have been paid, even though the trustee can avoid those payments, and the *Bishop* dicta which states that subsequent advances which have been paid are not available as offsets under (c)(4). Some courts simply apply this dicta in a "knee-jerk" fashion to deny the (c)(4) defense rather than working through the statute's difficult language.[67]

Much of the confusion surrounding this defense probably stems from its difficulty in application. The net result rule was easily ap-

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64. 53 Bankr. 630 (Bankr. S.D.N.Y. 1985).

65. *Id.* at 634.

66. *See also* Valley Candle Mfg. Co. v. Stonitsch (Matter of Isis Foods), 39 Bankr. 645, 653 (Bankr. W.D. Mo. 1984) (stating "[t]he fact that some invoice may or may not have been paid was not a relevant factor in the application of the subsequent advance rule of section 547(c)(4) to the factual circumstances presented in [*Bishop* and *Saco Local Dev. Corp.*]).

More recently, however, in Beiger v. Airtech Serv. Inc. (*In re* American Int'l Airways, Inc.), 56 Bankr. 551 (Bankr. E.D. Pa. 1986), the court held that the creditor was "not entitled to offset against claimed preferential transfers any new value which was subsequently paid for by the debtor." *Id.* at 555. Like *Bishop, American International* seems to be a case of an incomplete analysis reaching the correct result.

67. The potential impact of this result is enormous. The (c)(4) defense logically should be viewed as a safety net that protects a creditor who supplies credit based on money he already has received. According to the *Bishop* dicta, if (c)(2) was not a defense, the trustee arguably could avoid each of numerous payments made by the debtor during the preference period, even though the creditor had continued to supply credit based upon prior payments. Clearly, this is an inequitable result, but one which is possible given the confusion surrounding this statute.

plied because the court simply added all transfers and extensions of credit within the preference period and then compared them to see whether there was a net gain or loss to the estate. Under the subsequent advance rule, however, each extension of credit must be compared to the total preferential transfers made on or before that date. Accordingly, the subsequent advance may be used as an offset only to the extent it is equal to or less than the sum of preferential transfers to that date. The next subsequent advance must be compared to the total of the balance remaining of any preferential transfers not offset by the first subsequent advance, together with any preferential transfers made after the first subsequent advance, but prior to the second subsequent advance. This tedious analysis must be made for each subsequent advance in order to comport with the statutory framework. Any shift in the sequence of events can result in a dramatic change in the allowable offset. One possible paradigm for a correct analysis follows.

Assume that hypothetical creditor C experienced the following chronology of events in early 1987:

(a) Invoice #	(b) Date Debtor Became Obligated to Pay for Goods	(c) Amount	(d) Due Date	(e) Date Check Received	(f) Date Check Cleared	(g) Potential Preference
1	Jan 1	$ 1,100	Jan 11	Jan 20	Jan 22	yes*
2	Jan 10	1,200	Jan 20	Jan 20	Jan 22	?
3	Jan 19	1,300	Jan 29	Feb 10	Feb 12	yes
4	Jan 25	1,400	Feb 5	Feb 10	Feb 12	yes*
5	Feb 3	1,500	Feb 13	Feb 10	Feb 12	no
6	Feb 11	1,600	Feb 21	Feb 28	Mar 2	yes
7	Feb 15	1,700	Feb 25	Mar 5	Mar 7	yes*
8	Mar 1	1,800	Mar 11	Mar 10	Mar 12	?
9	Mar 10	1,900	Mar 20	Mar 28	Mar 30	yes
10	Mar 15	2,000	Mar 25	unpaid	unpaid	no

* Assuming subsection 547(c)(2) protects payments made on or before the due date.

C has painstakingly compiled this information, while the trustee's attorney has done little more than sue C for every payment C received in the preference period. C's chore has just begun, however, since he now must analyze the transactions in accordance with the statute. The first measuring date used in the analysis is the date the debtor became obligated to pay for the goods (column (b)). The next relevant date is the date on which payment on the obligation is due (column (d)). This date may be discerned by invoice terms, industry practice, or other methods, and is relevant mainly for the purpose of determining whether (c)(2) is a defense.[68] Finally, C must determine when he actually was paid for purposes of (c)(4), i.e., when he received the check or when it cleared the debtor's bank (columns (e) and (f)).

Ideally, attorneys for C and the trustee can agree upon all these dates. Practically, however, there will be differences of opinion or law over at least one of the dates, which will require two or more analyses to determine the possible results. For purposes of the following analysis, assume that agreement was reached on the first and second dates, but that C and the trustee had different ideas concerning when C was paid.

A. Assuming date check received is used.

(a) Date Check Received	(b) Amount	(c) Total Preference	(d) Date of Subsequent Advance	(e) Amount	(f) Available Offset*	(g) Cumulative Offset	(h) Net Preference
Jan 20	$ 1,100	$ 1,100					$ 1,100
			Jan 25	$ 1,400	$ 1,100	$ 1,100	0
Feb 10	1,300	2,400				1,100	1,300
Feb 10	1,400	3,800				1,100	2,700
			Feb 11	1,600	1,600	2,700	1,100
			Feb 15	1,700	1,100	3,800	0
Feb 28	1,600	5,400				3,800	1,600
Mar 5	1,700	7,100				3,800	3,300
			Mar 10	1,900	1,900	5,700	1,400
			Mar 15	2,000	1,400	7,100	0
Mar 28	1,900	9,000				7,100	1,900

Total Preferences	=	$ 9,000
Total Offset	=	7,100
Net Preference		$ 1,900

* Limited to lower of a) subsequent transfer or b) net preference immediately preceding subsequent transfer.

68. For purposes of this analysis, the due date is assumed to be ten days after the date the debtor became obligated to pay for the goods.

B. Assuming date check cleared is used.

(a) Date Check Cleared	(b) Amount	(c) Total Preference	(d) Date of Subsequent Advance	(e) Amount	(f) Available Offset*	(g) Cumulative Offset	(h) Net Preference
Jan 22	$ 1,100	$ 1,100					$ 1,100
Jan 22	1,200	2,300					2,300
			Jan 25	$ 1,400	$ 1,400	$ 1,400	900
			Feb 11	1,600	900	2,300	0
Feb 12	1,300	3,600				2,300	1,300
Feb 12	1,400	5,000				2,300	2,700
			Feb 15	1,700	1,700	4,000	1,000
			Mar 1	1,800	1,000	5,000	0
Mar 2	1,600	6,600				5,000	1,600
Mar 7	1,700	8,300				5,000	3,300
			Mar 10	1,900	1,900	6,900	1,400
Mar 12	1,800	10,100				6,900	3,200
			Mar 15	2,000	2,000	8,900	1,200
Mar 30	1,900	12,000				8,900	3,100

Total Preferences	=	$ 12,000
Total Offset	=	8,900
Net Preference		$ 3,100

* Limited to lower of a) subsequent transfer or b) net preference immediately preceding subsequent transfer.

Using the date more favorable to C results in a preference of $1,900.00, while using the less favorable date results in a preference of $3,100.00. Of course, C still has all the arguments available to him under (c)(2) to reduce this amount further.

As stated in *Paula Saker & Co.*,[69] the proper question is whether the subsequent advance has replenished the estate, not whether a subsequent advance has been paid or unpaid. If the subsequent advance is paid for with an unavoidable transfer, the creditor has added nothing to the estate and (c)(4) should provide no protection for him. However, if the subsequent advance is paid for with a transfer that is subject to avoidance, the creditor has created a net benefit for the estate and the transfer should be available as an offset under (c)(4).

69. *See supra* notes 64-66 and accompanying text.

IV. Conclusion

The seemingly sturdy defenses to a preference action provided by subsections 547(c)(2) and (c)(4) may provide little actual protection from a trustee's preference action. Some courts have read (c)(2) so restrictively that very few transactions will fall within the definition of "the ordinary course of business." Further, incomplete analyses of (c)(4) create the possibility for oppressive results not contemplated by the statute. However, there are certain steps, short of placing the debtor on a C.O.D. basis, which creditors may take before a debtor's bankruptcy proceedings to improve substantially the chances of successfully defending a preference action. They include:

1. Be wary of payments made later than the payment date set in a contract, or on an invoice submitted to the debtor. If the invoice states 2% 10/n11, and payments regularly are made twenty days after the invoice, the creditor may be faced with a future preference problem. Although most creditors flinch at the suggestion, it could be beneficial to lengthen credit terms to conform to actual credit practices.

2. In order to ensure that new value is extended after the creditor is paid, the creditor should wait until any check from the debtor clears the bank before new value is advanced.

3. Be wary of implementing any substantial change in credit policy, such as demanding payment via cashier's checks, or permitting a longer payment period. Such a change may be viewed later as beyond the ordinary course of business.

These suggestions may be contrary to the business aspects of the creditor's general credit policy. Accordingly, any implementation should be a business, not a legal, decision.

After the preference action is filed, the settlement process must begin. In negotiating a settlement from the creditor's side the first job is to diminish the trustee's potential recovery as far as possible. Typically, the trustee will file suit for an amount equal to the entire amount paid to the creditor during the preference period. The creditor should show the trustee, if possible, that some of the payments obviously are not avoidable, thereby reducing the total that the trustee sees as his potential recovery. To arrive at this point, the creditor must become very familiar with the timing of the transaction and perform the tedious and time-consuming calculations required under (c)(4).[70]

By utilizing these tactics, the creditor may fortify his position from future attacks or achieve a reasonable settlement stance. At the very least, this discussion should make the supplier aware that the credit risk of his sales does not end when he is paid.

70. Parenthetically, this exercise is a good example of a practical use for a personal computer in a legal setting. Once the model for this analysis has been developed, it is a relatively simple matter to adapt it to a different case.