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**Wolas v. Union Bank: When Should Interest Payments on Long Term Loans Qualify as "Ordinary Course of Business" Exceptions to Preferential Transfers**

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WOLAS v. UNION BANK: WHEN SHOULD INTEREST PAYMENTS ON LONG TERM LOANS QUALIFY AS "ORDINARY COURSE OF BUSINESS" EXCEPTIONS TO PREFERENTIAL TRANSFERS

ABSTRACT

This Note concerns the application of Bankruptcy Code sections 547(b) and (c) to a commercial loan preferential transfer case, Wolas v. Union Bank. The issues discussed are: (1) whether section 547(c)(2), the "ordinary course of business" exception, can be applied to transfers made on a loan whose term of repayment substantially exceeded 45 days; and (2) if that exception can be applied to such a loan, what "ordinary course of business" means. This Note summarizes the history of bankruptcy law as it applies to preferential transfers, focusing on the historical objectives of bankruptcy law; analyzes the facts of Wolas and In re CHG International, the latter being the case relied upon entirely for the legal reasoning in Wolas; and proposes a new "two plus two" test to determine when transfers are in the "ordinary course of business" and therefore eligible for protection under section 547(c) from the trustee's preferential transfer avoidance power.

INTRODUCTION

Determining when interest payments on long term loans may qualify as "ordinary course of business" exceptions to preferential transfers will have a substantial impact on the cost and availability of long term loans to businesses in financial difficulty. This Note will analyze the application of section 547(c)(2) of the Bankruptcy Code,1 the "ordinary course of business" exception to interest payments on long term debt in the context of a commercial bankruptcy case, Wolas v. Union Bank.2 In Wolas, the Ninth Circuit relied entirely upon the rationale of In re CHG International,3 a case decided several months before Wolas. In CHG International, the Ninth Circuit took the position that interest payments on long term debt never qualify for the "ordinary course of business" exception. This position was diametrically opposed to the position taken in Eighth and Tenth Circuit decisions of the previous several years on the same issue.

In a unanimous decision, the U.S. Supreme Court reversed the Ninth Circuit Court of Appeals and ruled that interest payments on long term debt could qualify as a section 547(c)(2) exception to the bankruptcy trustee's power of avoidance.4 The Supreme Court cited U.S. v. Ron Pair Enterprises5 for the rule that a party bears a very heavy burden of persuasion that Congress means something other than what the plain language of a statute

2. 921 F.2d 968 (9th Cir. 1990) [hereinafter Wolas I].
3. 897 F.2d 1479 (9th Cir. 1990).
The Supreme Court held that respondent Wolas, the trustee, failed to meet that burden. The Court's narrow decision expressly took no position on whether the actual payments made to Union Bank in the underlying case did qualify for a section 547(c)(2) exemption and remanded the case for further proceedings to the Ninth Circuit Court of Appeals.

Since the Supreme Court has decided that interest payments on long term debt may not be excluded, as a matter of law, from the "ordinary course of business" exception to the trustee's avoidance power, this Note will propose a method of determining when such interest payments fall within the exception. Section I of this Note will discuss basic but relevant bankruptcy concepts. Section II will provide a context for the Wolas case in the form of a short history of bankruptcy and preferential transfers. Section III will review the facts and posture of Wolas and its progenitor case, CHG International. Section IV will discuss the legal reasoning of the several circuits in opposition. Finally, Section V will suggest a proposed solution for analyzing cases involving interest payments on long term debt. The proposed solution combines the two step method advanced by DeSimone with a more precise definition of "ordinary course of business" derived from precedent, commercial practice, and bankruptcy policy.

I. RELEVANT BANKRUPTCY CONCEPTS

Two primary goals of bankruptcy are equality of distribution of a debtor's assets to equally situated creditors and maximization of a debtor's assets available for distribution to creditors.

Both goals are served by laws that discourage the dismemberment of a debtor's assets prior to bankruptcy and obviate the need for creditors to "race to the courthouse" to protect their positions. Without these laws, creditor acceleration of demands on debtors, in anticipation of financial collapse, would diminish the size of the estate available to all creditors and result in grossly unequal distribution of assets. The general line of thought is that a going concern in bankruptcy reorganization has at least the possibility of increasing the assets available to creditors, usually has more value than the sum of its separate parts, and may avoid liquidation altogether with enough

7. Id.
8. Id.
10. Id. at 98-99.
time to restructure its business.\textsuperscript{13}

To achieve these goals, unsecured creditors are not permitted to keep payments made to them by debtors during the period just prior to bankruptcy, when the debtor is near financial collapse. These payments are termed "preferential transfers" and are avoidable\textsuperscript{14} by the bankruptcy trustee. Section 547\textsuperscript{(b)} of the Bankruptcy Code\textsuperscript{15} specifies the elements of a preferential transfer that the trustee must prove to avoid the transfer.\textsuperscript{16} The elements of section 547\textsuperscript{(b)} can be summarized\textsuperscript{17} as including any transfer of the debtor’s property that is: (1) for the benefit of a creditor, (2) made on account of an antecedent debt, (3) made while the debtor is insolvent,\textsuperscript{18} (4) made within 90 days of bankruptcy; and that (5) enables the creditor to receive more than the creditor would have received in a Chapter 7 liquidation if the payment had not been made.\textsuperscript{19}

\begin{footnotesize}
\begin{enumerate}
\item Avoidance of a transfer means that the trustee can compel the creditor who received such a transfer to disgorge it. The creditor will also be liable for interest and the costs of recovery.
\item 11 U.S.C. § 547\textsuperscript{(b)} reads:

\begin{quote}
(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property -
\begin{enumerate}
\item to or for the benefit of a creditor; [and]
\item for or on account of an antecedent debt owed by the debtor before such transfer was made; [and]
\item made while the debtor was insolvent; [and]
\item made -
\begin{enumerate}
\item on or within 90 days before the date of filing of the petition;
\item or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of the transfer was an insider;
\end{enumerate}
\end{enumerate}

and
\begin{enumerate}
\item (5) that enables such creditor to receive more than such creditor would receive if -
\begin{enumerate}
\item the case were a case under chapter 7 of this title; [and]
\item the transfer had not been made; and
\item such creditor received payment of such debt to the extent provided by the provision of this title.
\end{enumerate}
\end{enumerate}
\end{quote}

\item There is a rebuttable presumption that the debtor was insolvent during the 90 day period prior to the bankruptcy filing. 11 U.S.C. § 547\textsuperscript{(f)} (1984). This requirement to show insolvency is delineated in § 547\textsuperscript{(b)}(3) and should not be confused with the 90 day window (one year if an insider) provided in § 547\textsuperscript{(b)}(4).
\item This provision is a little confusing to the uninitiated. Basically it states that only transfers that result in some financial advantage to the creditor that would not have been obtained by waiting with the other creditors is deemed a preferential transfer. This provision is important in distinguishing payments made to a fully secured creditor from those made to an unsecured (or undersecured) creditor. Payments made to a secured creditor that meet the requirements of the first four elements of § 547\textsuperscript{(b)} still do not meet the requirements of the fifth element, financial advantage to that creditor that would not have been obtained by waiting his turn. A secured creditor at a chapter 7 liquidation will take all assets in satisfaction of the secured debt before
\end{enumerate}
\end{footnotesize}
The provisions of section 547(b) are so broad that almost any transfer made to an unsecured (or undersecured) creditor within 90 days of bankruptcy for an antecedent\textsuperscript{20} debt is a preference that is avoidable by the trustee.\textsuperscript{21} The effect of this provision on a troubled business, if left unmodified, would be certain and disastrous. No supplier would provide stock on credit and no creditor would provide trade credit without worrying that any payments made by the debtor might someday be recoverable by a trustee. This termination of supplies and operating credit would cause the very results the bankruptcy laws were designed to prevent: accelerated slide into bankruptcy and consequent diminution of assets.\textsuperscript{22}

To prevent these undesirable results, seven exceptions were created that placed certain types of transfers outside the reach of the trustee’s avoidance powers, even if the transfers met all of the requirements of section 547(b). These seven exceptions were codified in section 547(c).\textsuperscript{23} The first two exceptions\textsuperscript{24} were established for the very purpose of permitting suppliers and trade credit lenders the ability to deal with troubled businesses without risk of losing payments (transfers) to an avoiding trustee.\textsuperscript{25} The first exception, section 547(c)(1), involves contemporaneous exchanges for new value. The second exception, section 547(c)(2), involves transfers in the “ordinary course of business.”

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any unsecured creditors will be allowed to take any assets for their debt. Therefore, all payments made to secured creditors, regardless of time frame, are not preferential transfers and are not avoidable by the trustee. The purpose of this fifth provision is to protect the position of secured creditors.

20. A contemporary exchange of value for value is not considered a preferential transfer because it does not deplete the estate at the time it is made. Assets coming into the estate are equally available to all unsecured creditors equally situated. In contrast, payments made on antecedent debt bring no equivalent asset to the estate.

21. DeSimone, supra note 9, at 97.
22. H.R. REP. No. 95-595, supra note 12, at 177.
24. 11 U.S.C. § 547(c) reads in part:

(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;
(2) to the extent that such transfer was -
   (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; [and]
   (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
   (C) made according to ordinary business terms;

II. PREFERENTIAL TRANSFERS AND BANKRUPTCY HISTORY

The history of bankruptcy law provides a clear progression of preferential transfer theory. Modern bankruptcy law, with statutory exceptions to preferential transfer prohibitions, are modified codifications of earlier case law exceptions. These case law exceptions were themselves a product of the particular statutory preferential transfer prohibitions of the time. Preferential transfer prohibitions and exceptions evolved together as a system. To understand the meaning of modern prohibitions and exceptions, it is important to understand prior prohibitions and exceptions and why they changed and evolved to their present state.

A. Pre-1898 Bankruptcy Law

The concept of preferential transfers has a long history. The first mention of preferences came in the Bankruptcy Act of 1841, which defined preferences as transfers that are made “in contemplation of bankruptcy . . . for the purpose of giving any creditor . . . priority over the general creditors. . . .”26 The Bankruptcy Act of 1867 established a knowledge test which required showing that the creditor knew both that the debtor was insolvent and the transfer fraudulent in order to trigger avoidance of the transfer.27 The 1867 Act also established the requirement that the trustee show intent on the part of the debtor to prefer a creditor and further established a four-month window preceding bankruptcy as the period in which transfers would be considered preferential.28

B. The 1898 Bankruptcy Act

The modern era of bankruptcy law began with enactment of the Bankruptcy Act of 1898.29 The most significant change wrought by this legislation concerning preferential transfers was elimination of the requirement that the debtor have a conscious intent to give a preference.30 The definition of a preference under the 1898 Act was very similar to the current section 547(b) definition except that the trustee was required to prove debtor

26. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (repealed 1843) See also McCoid, supra note 13, at 253 and DeSimone, supra note 9, at 101.
27. Bankruptcy Act of 1867, ch 176, § 35, 14 Stat. 517 (repealed 1878), see DeSimone, supra note 9, at 102.
28. Id.
29. DeSimone, supra note 9, at 102.
insolvency at the time of the transfer,\textsuperscript{31} and to show that the creditor had reasonable cause to believe that the debtor was insolvent when the transfer was made.\textsuperscript{32}

The Bankruptcy Act of 1898 contained no exceptions to the avoidable preferential transfers comparable to the modern section 547(c) exceptions. The requirement that the trustee show that the creditor had "reasonable cause to believe that the debtor was insolvent" protected most ordinary business transactions.\textsuperscript{33} Another protection for the creditor was the "current expense rule."\textsuperscript{34} This judicially created rule exempted from avoidance payments made for such current expenses as wages, rent, advertising, and warehousing expenses.\textsuperscript{35} The rule was developed to reflect the status of such transactions as current and not antecedent debt and therefore not resulting in a preferential treatment of creditors.\textsuperscript{36} Importantly, the 1898 Act made no distinction between long term and short term debt.\textsuperscript{37}

\textbf{C. The 1978 Bankruptcy Act}

The next major change to the bankruptcy laws affecting preferential transfers occurred when the Bankruptcy Act of 1978 was enacted.\textsuperscript{38} The 1898 Bankruptcy Act requirement that the trustee show "reasonable cause to believe that the debtor was insolvent" before he could avoid a transfer was a heavy burden and invariably led to litigation over the subjective knowledge of the transferee, a difficult evidentiary area.\textsuperscript{39} There also seemed little reason for treating the ignorant creditor better than the knowledgeable, diligent creditor.\textsuperscript{40} In 1978 Congress passed the Bankruptcy Reform Act, eliminating the subjective "reasonable cause to believe" test and adopting the five elements of a preferential transfer found in the modern section 547(b).\textsuperscript{41} Enactment of the 1978 Act also introduced, for the first time,

\begin{footnotesize}
\begin{enumerate}
\item This is in contrast to the modern law which establishes a rebuttable presumption of insolvency for 90 days prior to the date of bankruptcy filing. 11 U.S.C. § 547(f) (1984).
\item DeSimone, supra note 9, at 103.
\item In re Brown, 20 B.R. 554, 555 (Bankr. S.D.N.Y. 1982); see DeSimone, supra note 9, at 103.
\item Michael Kaye, Preferences Under the New Bankruptcy Code, 54 AM. BANKR. L.J. 197, 202 (1980).
\item Id.
\item 1898 Bankruptcy Act, ch. 541, § 60.
\item DeSimone, supra note 9, at 105.
\item DeSimone, supra note 9, at 105.
\item See supra note 16.
\end{enumerate}
\end{footnotesize}
statutory exceptions\textsuperscript{42} to the preference law\textsuperscript{43} designed for the specific purpose of achieving bankruptcy policy goals.\textsuperscript{44} These revisions removed the trustee's burden of proving a debtor's subjective knowledge and substituted a rebuttable presumption of insolvency during the 90 days prior to bankruptcy.\textsuperscript{45} The 1978 Act also made the trustee's task of proving a preferential transfer a simple matter. The changes effectively shifted the real burden of any litigation regarding preferential transfers to the transferee who must prove that the transfer falls within one of the specified exceptions delineated in section 547(c).\textsuperscript{46}

Transfers made in the "ordinary course of business," the subject of this Note, were one of the new statutory exceptions in the 1978 Act. Under the 1978 Act, section 547(c)(2) contained four elements, or tests, that the transferee had to meet to place those transfers that otherwise met the requirements of an avoidable preferential transfer outside the reach of the trustee.\textsuperscript{47} The section read as follows:

\begin{quote}
(c) the trustee may not avoid under this section a transfer . . .

\ldots

(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. . . .\textsuperscript{48}
\end{quote}

This exception was enacted to protect certain creditors from the long reach of section 547(b). Without this exception, payments made in the ordinary course of business, that merely enabled the debtor to continue current operations of the debtor's business, would be recoverable by a trustee. Congressional intent was clearly stated in the legislative reports: "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

\textsuperscript{42} The "current expense rule" was a judicial exception. Herbert, supra note 34, at 679. The "reasonable cause to believe" requirement was an element in the trustee's prima facie case for a preferential transfer prior to 1978. 1898 Bankruptcy Act, § 60.

\textsuperscript{43} Charles J. Young, Preferences Under the Bankruptcy Reform Act of 1978, 54 AM. BANKR. L.J. 221, 225 (1980).

\textsuperscript{44} Desimone, supra note 9, at 106.


\textsuperscript{46} Nutovic, supra note 11, at 178-79.


\textsuperscript{48} Id.
creditors during the debtor's slide into bankruptcy. 49

The 45-day test, created as part of the section 547(c)(2) exception clearly protected only short term loans from avoidance. The rigidity of this new 45-day test, however, disturbed certain creditors, especially providers of consumer credit because consumer purchases are often made more than 45 days before payment is first due. 50 The 45-day rule was also the focus of much litigation as the courts wrestled with the problem of determining exactly when a debt was incurred, the trigger point for the 45-day rule. 51 Most courts followed the Barash rule that a debt was incurred at the moment when the debtor first became legally bound to pay. 52

In addition to being the focus of the majority of the litigation surrounding preferential transfers, the 45-day rule had other serious problems. 53 Originally selected because it was thought that 45 days reflected the normal trade cycle, the 45-day rule left credit transactions that were even slightly longer completely outside the protection of the exception. 54 Many industries have billing cycles longer than 45 days. It simply made no sense, from either a bankruptcy policy or commercial economic point of view, to draw a rigid line of demarcation that protected those who provided credit within the 45-day period but left vulnerable those who provided credit outside the 45-day period. 55 As the cases mounted, many courts also found that often neither the debtor nor the creditor was free to adjust its borrowing and lending cycles. 56 The periods of these cycles were often derived not merely from custom and tradition but driven by industry practices and factors that were entirely outside of the debtor's or creditor's control. 57

D. The 1984 Bankruptcy Amendments and Federal Judgeship Act

In this context, Congress passed the Bankruptcy Amendments and Federal Judgeship Act of 1984. 58 This Act, focused mainly on solving the

49. S. REP. NO. 989, 95th Cong., 2d Sess. 88 (1978) (emphasis added); see also H.R. REP. 95-595, supra note 12, at 373; Weintraub & Resnick, supra note 17, at 265.

50. Kaye, supra note 35, at 203. A typical credit card transaction might have the debtor purchasing on the 25th of March, the credit card bank billing the purchase on the April 30th statement for payment due on May 15th. Since the time period is measured from when the debt is first incurred (March 25th) to the date of transfer (May 15th), this transaction would exceed the 45-day limit and thus such a transfer would not be protected from avoidance by the trustee.

51. Nutovic, supra note 11, at 177.

52. DeSimone, supra note 9, at 108 (citing Barash, 658 F.2d at 510).

53. Id. at 111.

54. Fortang & King, supra note 39, at 1168-69.

55. DeSimone, supra note 9, at 111.

56. See Fortang & King, supra note 39, at 1168.

57. Id.

jurisdictional problem of a recent Supreme Court decision, also amended section 547(c)(2) by deleting subsection (B), the 45-day rule. The remainder of section 547(c)(2) was left intact. With elimination of the 45-day limit in 1984, the federal circuits have split along several lines in deciding the applicability of section 547(c)(2) to transfers other than payments made on typical short term trade credit. The Ninth Circuit decision in Wolas held that interest payments on a revolving line of credit were indistinguishable from interest payments made on long term credit and that interest payments on long term credit were never covered by the section 547(c)(2) "ordinary course of business" exception to avoidable preferences. This latter pronouncement relied entirely on the Ninth Circuit's seminal case on the issue decided earlier that year, CHG International.

On the narrow issue of whether interest payments on long term debt never qualified for the "ordinary course of business" exception, the Supreme Court reversed and remanded the case to the Ninth Circuit. The Supreme Court offered no guidance, however, as to what "ordinary course of business" means or how that term should be applied to the Wolas case. Other courts have provided such guidance. The Tenth Circuit, for example, in Fidelity Savings and Investment v. New Hope Baptist, found that interest payments on long term loans could qualify for the "ordinary course of business" exception if the loan met the literal requirements of section 547(c)(2). Also, the Eighth Circuit, in In re Iowa Premium Service Co., found that the obligation to pay interest accrued over the time the debtor held the principal and therefore each interest payment was for a short

59. The main focus of the 1984 Act was to correct the jurisdictional problems created by the 1982 Supreme Court decision in Northern Pipeline Const. Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982).

60. Amazingly, there is practically no legislative history with respect to the elimination of the 45 day rule. There is only a single exchange between Senators Dole and DeConcini concerning § 547(c)(2) which occurred during the floor statement on the 1984 Amendment. It sheds little light on the intent of Congress in deleting the 45-day requirement. See DeSimone, supra note 3, at 112 (note 150) quoting the exchange recorded in Floor Statement on H.R. 5174 (P.L. 98-353), 130 CONG. REC. 8887, 8897 (June 29, 1984).

61. The Ninth Circuit, which held fast to limiting the exception to payments made on short term trade credit, traced the line of cases in its reasoning through Barash v. Public Finance Corp., 658 F.2d 504 (7th Cir. 1981); and In re Bourgeois, 58 B.R. 657 (Bankr. W.D. La. 1986). Other circuits have developed their own line of cases which interpreted the elimination of the 45 day limit as expanding the applicability of the exception to other types of transfers, including interest payments on long term debt. Fidelity Sav. & Invest. v. New Hope Baptist, 880 F.2d 1172 (10th Cir. 1989); In re Iowa Premium Service Co., 695 F.2d 1109 (8th Cir. 1982); In re Smith-Douglass, Inc. 842 F.2d 729 (4th Cir. 1988); In re Xonics Imaging, 837 F.2d 763 (7th Cir. 1988).

62. Wolas I, 921 F.2d at 969.
63. Id.
64. Wolas II, 112 S. Ct. at 533.
65. Id.
66. 880 F.2d 1172 (10th Cir. 1989).
67. Id. at 1175.
68. Iowa Premium, 695 F.2d 1109.
term debt.69

III. CASE FACTS AND POSTURE

The element structure of section 547(b) and (c) makes the application of those sections especially sensitive to subtle differences in facts. Because of this structure, the application of sections 547(b) and (c) to two cases with similar facts can result in radically different outcomes. There are no gradations of a trustee’s power to avoid a transfer. If the transfer meets the element requirements of section 547(b), then the trustee has the complete power to avoid the entire transfer. If the trustee fails to meet any element of section 547(b), then the trustee is without power to avoid any part of the transfer. Application of section 547(c) exceptions are similar “all or nothing” affairs. This section provides a summary of the facts. Section IV will discuss these cases as they relate to the ordinary course of business exception to preferential transfers.

A. Wolas v. Union Bank

Debtor ZZZZ Best70 entered into a $7 million unsecured revolving line of credit with an eight-month term with creditor Union Bank in December 1986.71 The bank drew monthly interest payments from the debtor’s account automatically.72 Under the terms of the agreement, the debtor could choose whether to pay interest or principal each month.73 The debtor made several payments of interest until July 1987, when it declared bankruptcy.74 The trustee, Wolas, brought an action to recover those interest payments as preferential transfers avoidable under section 547(b).75 The bank attempted to retain the payments by asserting that the payments were made in the ordinary course of business, and thus were exempted from recovery by section 547(c)(2).76 The bankruptcy court found for the bank as a matter of law and the district court affirmed.77 The Ninth Circuit reversed. The court relied entirely on its own opinion in CHG International where it treated

69. Id. at 1111.
70. ZZZZ Best presented itself as a commercial rug cleaning company. It was actually nothing more than a cover for an enormous “Ponzi” scheme. It managed to dupe some of the largest Wall Street investment banking firms in the course of collecting several million dollars in venture capital while dispensing a fraction of that capital to early investors as a “return” in the classic “Ponzi” pyramid scheme. Richard W. Stevenson, Star Entrepreneur’s Fall From Grime, N.Y. Times, July 9, 1989, at D1.
71. Wolas I, 921 F.2d at 969.
72. Id.
73. Id.
74. Id.
75. Id.
76. Id.
77. Id.
interest payments on long term loans as always avoidable by the trustee as preferential transfers. The Supreme Court reversed on the issue of avoidability as a matter of law and remanded the case to the Ninth Circuit. 78 Neither the Ninth Circuit nor the Supreme Court, however, reached the issue of whether payments made in furtherance of a “Ponzi” scheme were entitled to the section 547(c)(2) ordinary course of business exemption. 79

B. CHG International

The facts in CHG International are considerably more complex than the facts in Wolas. The CHG International case involved payments of interest on loans that were undersecured 80 at the time of the bankruptcy filing. 81 Debtor CHG, a real estate development corporation, obtained two loans from creditor Barclays Bank before filing for bankruptcy on December 5, 1984. 82 At issue were the interest payments made on both loans during the 90 day period prior to the bankruptcy filing. 83

The first loan, a one-year line of credit, made on July 15, 1982, and renewed on October 27, 1983, for $1,200,000, was secured by a $1,200,000 certificate of deposit (CD), and evidenced by a promissory note that required CHG to make monthly interest payments on the unpaid principal balance each month. 84 There was no explicit provision in the promissory note allowing for prepayment prior to the maturity date, October 30, 1984. 85 CHG made regular monthly payments according to the terms of the loan, missing only one payment, in June 1984. 86 CHG made one interest payment of $14,224.99 on September 17, 1984, within the 90-day pre-bankruptcy

78. Wolas II, 112 S. Ct. at 533.
79. The courts have found that such transfers in furtherance of a fraudulent scheme always violate the three requirements of § 547(c)(2). DeSimone, supra note 9, at 119 n.212.
80. Payments of principal in the case of fully secured or over secured loans clearly do not meet the § 547(b)(5) requirement for preferential avoidable transfers since the payments do not deplete the estate, they merely exchange cash for an equivalent release of security interest. See supra note 15. A competing unsecured or undersecured creditor will be in no worse position after such transfers.
81. Payments of principal on unsecured or undersecured antecedent debt within the 90 day window will satisfy the § 547(b) requirements for preferential, avoidable transfers. The issue in these cases will always be whether the payments came under the § 547(c)(2) ordinary course of business exception.
82. Interest payments on undersecured or unsecured debt within the 90 day window are at issue here, however, the same analysis would apply to interest payments on fully secured debt, since, unlike the payment of principal on fully secured debt, no equivalent release of security interest occurs upon payment of interest. As we will see later in the Note, this type of situation is especially complex because the trustee’s avoidance is susceptible to attack on either § 547(c)(1), contemporaneous exchange for new value given, or § 547(c)(2), ordinary course of business.
83. CHG Int’l, 897 F.2d at 1480.
84. Id.
85. Id. at 1481.
86. Id. at 1480.
87. Id.
88. Id.
filing window. 87 Unable to meet the demand for payment made by Barclays on October 29, 1984, CHG directed the holder of its CD to liquidate and transfer the proceeds to Barclays. 88 This was done, but because of an early withdrawal penalty, Barclays received only $1,164,125.32. 89 

Barclays also made a $1,000,000 loan to CHG on May 1, 1984. 90 This loan was evidenced by a promissory note that required payment of the entire principal on December 28, 1984, and monthly payment of interest. 91 This second loan was secured by deeds of trust on two parcels of property that had so little value the loans were effectively unsecured. 92

CHG subsequently defaulted on an underlying real estate contract and forfeited its interests in one parcel to the contract vendors, realizing no proceeds from the later sale. 93 The second parcel was subsequently sold at auction with the proceeds unable to satisfy the senior creditors; again CHG realized no proceeds from the sale. 94 As with the first loan, CHG made its regular interest payments on time, missing only its June payment, and made one interest payment of $12,513.89 during that 90-day pre-bankruptcy window, on September 17, 1984. 95

Two years after the bankruptcy was filed, on December 5, 1986, the trustee for CHG filed a complaint in bankruptcy court asserting his right under section 547(b) 96 to recover the two interest payments made on September 17, for the benefit of the estate and moved for summary judgment. 97 Barclays denied that the payments were preferential, asserted an affirmative defense that the payments were excepted from avoidance by the "ordinary course of business" provision of section 547(c)(2), and also moved for summary judgment. 98 The bankruptcy court denied Barclays motion for summary judgment and found as a matter of law that section 547(c)(2) was not available to Barclays because the debts in question were long term loans, not ordinary trade credits. The bankruptcy court later

87. Id.
88. Id.
89. Id.
90. Id.
91. Id.
92. The first parcel involved a $500,000 deed of trust on 85 acres of a 127 acre undeveloped lot. The entire 127 acre lot was valued at less than $510,000. The deed of trust was junior to two other interests: a $2,000,000 deed of trust held by a savings and loan association and a $350,000 claim by contract vendors. There was a $500,000 deed of trust on a second parcel. This deed of trust was also junior to two other deeds of trust; one held by a bank for $2,122,500, the other held by a savings and loan association for $2,850,000. Id.
93. CHG Int'l, 897 F.2d at 1481.
94. Id.
95. Id.
97. CHG Int'l, 897 F.2d at 1481.
98. Id.
granted the trustee’s motion for summary judgment.\footnote{Id. The bankruptcy court awarded $26,738.88 plus interest and costs. \textit{Id.}}

On appeal to the district court, Barclays maintained that although the transfers were preferential, they were exempted from avoidance by section 547(c)(2). The district court granted summary judgment to Barclays, reversing the bankruptcy court decision.\footnote{\textit{In re CHG Int’l Inc.}, 87 B.R. 647 (Bankr. W.D. Wash. 1988).} Upon appeal by CHG, the Ninth Circuit reversed and remanded.\footnote{\textit{CHG Int’l}, 897 F.2d at 1480. The issue here is the rigidity of the Ninth Circuit’s rule that interest payments on long term debt are \textit{never} covered by the “ordinary course of business” \textsection{547(c)(2)} exception, and that the obligation to pay interest \textit{always} accrues when the promissory note is signed. As several other circuits and a number of commentators make clear, a more flexible, context oriented test would better implement the policy and intent behind \textsection{547(c)(2)}. \textit{Id.} at 1487.} The court concluded that interest payments on long-term debt were not intended to be covered under the ordinary course of business exception, and that CHG’s obligation to make the interest payments at issue accrued when the notes were signed.\footnote{\textit{Wolas I}, 921 F.2d at 969.}

\section*{IV. Discussion}

The Ninth Circuit’s decision on the avoidability of interest payments on long term debt in \textit{Wolas} relied entirely upon its own reasoning in \textit{CHG International}.\footnote{In \textit{Barash}, the court held that interest payments on short term debt are \textit{legally} bound to pay. See DeSimone, supra note 9, at 108. The determination of exactly when a debt is incurred goes directly to the issue of whether a payment is for a long term debt when the transfer is made, or whether it is for a short term debt. The “legally bound to pay” in CHG refers to legally bound to pay the interest that was in fact paid during the 90 day pre-filing window.} There were two major issues in \textit{CHG International}: (1) when did CHG become legally bound to pay the interest;\footnote{\textit{CHG Int’l}, 897 F.2d at 1482.} and (2) whether the loans met the requirements of section 547(c)(2), the “ordinary course of business” exception, thereby exempting the payments from the avoidance power of the trustee.\footnote{This was the Ninth Circuit standard for distinguishing long term debt from short term debt.}

\subsection*{A. Determining When the Debtor Becomes Legally Bound to Pay}

The answer to the first issue, the determination of when CHG first became legally bound to pay the interest payments which it made during the 90 day window, determines whether the interest payments were for a debt created more than 45 days\footnote{If CHG became legally bound to pay those interest payments when the promissory notes were signed, then the interest payments in question were made well after 45 days had elapsed from the incurrence of the debt.} before the payment\footnote{\textit{Id.} at 1487.} and therefore avoid-
able, or whether the interest payments were made for a debt incurred daily for each day the loan principal was held by the debtor. If the latter is held, then the payments, although still for an antecedent debt, may qualify for a section 547(c) exception, specifically: a contemporaneous exchange for new value given, or a payment made in the ordinary course of business. If either exception is applicable, then the transfer is outside the reach of the trustee’s power to avoid the transfer. The test for this issue is whether CHG was obligated to pay interest from the moment it signed the promissory note, regardless of whether it prepaid the loan principal, or whether the obligation for paying each month’s interest matured only each month as the principal was held for that month.

The Ninth Circuit held that a debtor becomes legally bound to pay when “the debtor obtains a property interest in the consideration exchanged giving rise to the debt.” The court held that the law of the state of Washington governed and that “under Washington law, the obligation to pay interest is fixed upon execution of the note.”

Under similar circumstances, the Eighth Circuit, in In re Iowa Premium Service held that debt was incurred daily as interest accrues. The Eighth Circuit reasoned that a fixed obligation to pay interest only becomes due each day as the principal is held and used for one more day. The court asserted that “interest is simply rent for the use of money” and analogized the payment of this “rent” for the principal to the rent a debtor would pay for leased property, or the payment a debtor would make to a utility for the use of its electricity.

The Eighth Circuit supported its position by asserting that treatment of

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108. If the loan does not qualify for the § 547(c)(2) “ordinary course of business” exception, then the interest payments made are avoidable under the § 547(b) power.

109. This would provide an exception under § 547(c)(1).

110. This would provide an exception under § 547(c)(2). If the obligation to pay the interest accrued monthly, then the “debt” (obligation to pay the interest) was a “short term” debt, well within the accepted definition of a current expense (pre-1978), the 45-day rule (1978-1983), or all of the Circuits interpretation of an “ordinary course of business” payment (including the Ninth Circuit).

111. Although still considered a preferential transfer, if the transfers meet the requirements of § 547(c), they are outside the power of the trustee to avoid.

112. CHG Int’l, 897 F.2d at 1486.

113. Id. at 1486 (citing 4 COLLiER ON BANKRUPTCY ¶ 547.38).

114. Id.

115. Id. (citing Pedersen v. Fisher, 245 P. 30, 32 (Wash. 1926)).

116. Iowa Premium, 695 F.2d at 1111 (the debtor is first legally obligated to pay the interest only after holding onto the principal for one more day).

117. Id.

118. Id.

119. Id.

120. Id. These examples were cleverly selected by the Eighth Circuit court to match the very examples used to illustrate the pre-1978 judicially created “current expenditure rule,” the direct ancestor of the § 547(c)(2) “ordinary course of business” exception.
interest payments on loans as current expenditures was consistent with the policies of the Bankruptcy Act. The court, citing Levin’s article, *An Introduction to the Trustee’s Avoiding Powers*, said that “the exception to the preference section was intended to insulate ordinary trade credit transactions that are kept current.” The court asserted that a bank’s lending of its money to a debtor is like any other business transferring its product to a debtor and therefore, the bank is entitled to the same protections available to a trade creditor who deals in tangible goods. To deny banks this protection is to discourage them from giving loans to marginal debtors, thereby defeating the bankruptcy law goal of maximizing the estate available to creditors by not accelerating the debtor’s slide into bankruptcy.

The Ninth Circuit attacked the *Iowa Premium* decision along two lines. First, citing *In re Western World Funding*, which involved a consumer installment loan agreement, the Ninth Circuit insisted that a debt is incurred on the principal and the interest when a loan agreement is signed and the debtor obtains the funds, not as each monthly payment falls due. The court said the obligation to pay the interest is established at the time the debtor obtains the funds “even if at that time the debtor’s obligation to pay interest is unmatured and contingent.” The court went on to explain that “this is so because once the debtor receives the funds, consideration for payment of principal and interest has passed.”

In the second line of attack, the Ninth Circuit distinguished the facts in *Iowa* from the facts in *CHG International*, finding that in *Iowa* the promissory note was “subject to payment on demand by the creditor and prepayment at any time at the option of the debtor,” while in *CHG International* no such expressed options existed. The Ninth Circuit

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121. *Id.* at 1112.
124. In the view of the Eighth Circuit, the “product” of a bank is its money.
125. *Iowa Premium*, 695 F.2d at 1112.
126. *Id.*
127. *CHG Int’l*, 897 F.2d at 1486.
129. *CHG Int’l*, 897 F.2d at 148.
130. *Id.*
131. *Id.*
132. The Ninth Circuit, in this second argument, asserted that even if the *Iowa Premium* holding of contingent interest being a contemporaneous exchange is accepted, the facts of *CHG International* indicate that the interest obligation was never contingent on anything, but owed from the time the debtor received the proceeds of the loan. *Id.* at 1487.
133. *CHG Int’l*, 897 F.2d at 1487.
134. *Id.*

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relied upon a 1926 case, Pedersen v. Fisher, to assert that under Washington law, "if a note is silent regarding payment the borrower has no right to pay before maturity." On this basis, the court concluded that the obligation to pay the interest for the entire period of the loan remained even if the debtor repaid the principal immediately. The court viewed the monthly interest payments as similar to principal payments in an installment loan, mere payments spread over time for a debt already incurred.

The Ninth Circuit's first line of attack, concerning the passage of consideration for interest at the time the note was signed, at its heart, is based on circular reasoning. The court asserted that an obligation to repay both the principal and interest is binding at the outset because "consideration for payment of principal and interest has passed." There is no doubt that the loan proceeds constitute consideration for repayment of the principal, but whether it constituted consideration for the payment of interest is the very question at issue. The better view is that the consideration consists of the loan proceeds and the fact that the creditor does not demand payment of the principal nor accelerate the loan. This "declining to act" consideration by the creditor occurs monthly or daily, not all at once at the outset. If the interest payments are contingent upon the period that the debtor holds the principal and the creditor declines to demand payment, then surely the interest becomes an obligation only when this creditor's consideration passes to the debtor.

The second line of attack by the Ninth Circuit, that under Washington law, a lender is not obligated to accept prepayment of a loan prior to its maturity date if the contract is silent as to prepayment, is undoubtedly a correct interpretation of Washington law for fixed term loans. However, as appropriate as this rule may have been to CHG, the loan in question in Wolas was a revolving credit line with an outer limit of eight months to repay the principal. A revolving line of credit, by its very nature, is not a fixed term loan. The terms of the agreement in Wolas gave the debtor the option each month to repay all or any part of the principal. Interest owed each month depended upon the balance of the credit used during that month, and could have been zero for any month in which the loan balance

135. 245 P. 30 (Wash. 1926).
136. CHG Int'l, 897 F.2d at 1487.
137. Id.
138. Id.
139. Id.
140. Iowa Premium, 695 F.2d at 1111 ("Interest is simply rent for the use of money.").
141. The consideration would be the loan principal and the forbearance to demand immediate payment.
143. Wolas I, 921 F.2d at 969.
144. Wolas II, 112 S. Ct. at 528.
was zero.\textsuperscript{145}

In \textit{CHG International}, one of the loans was a revolving line of credit, the other, although a fixed term loan, in no other way resembled the debt at issue in \textit{Pedersen}.\textsuperscript{146} Even if the second CHG loan did resemble the loan in \textit{Pedersen}, that \textit{Pedersen} was decided correctly is not altogether clear.\textsuperscript{147} The modern trend is that the mortgagor is “liable only for interest accrued to the time of payment unless the mortgage specifically provides for an interest penalty”.\textsuperscript{148}

\textbf{B. Determining Whether the Loan is in the “Ordinary Course of Business”}

The second issue, whether the loans met the requirements of section 547(c)(2), the “ordinary course of business” exception, and thereby made the interest payments exempt from the avoidance power of the trustee, hinges upon: (1) the meaning of “ordinary course of business,” and (2) how a court should interpret congressional intent from congressional silence. The Ninth Circuit viewed the section 547(c)(2) “ordinary course of business” exception as merely augmenting the section 547(c)(1) “contemporaneous exchanges for new value given,” enlarging the exception to encompass “substantially contemporaneous exchanges” like those involved in trade credit transactions.\textsuperscript{149} Prior to 1984, the limits of “substantially” were clear. Section 547(c)(2)(B) specified an exact limit of 45 days. The Ninth Circuit viewed that prior restriction as existing to limit the exception to trade credit and expressly excluding (not protecting) long term debt.\textsuperscript{150} In explaining why trade credit should be protected from avoidance and long term debt payments

\textsuperscript{145} It should be noted that the debtor also paid a small “loan commitment fee” each month that was based upon the \textit{unused} credit in the credit line. This monthly fee would be at a maximum when the loan balance was zero. \textit{Id.}

\textsuperscript{146} In \textit{Pedersen}, the issue was whether the twelve quarterly interest payments for a three year loan could be compelled even though the creditor, Pedersen, foreclosed on the property in satisfaction of the principal one year after the loan was made. \textit{Pedersen}, 245 P. at 31. In \textit{CHG International}, there was no foreclosure of a longer loan and no indication that the creditor would not have accepted payment of principal in complete satisfaction of the debt. \textit{CHG Int’l}, 897 F.2d at 1480.

\textsuperscript{147} Frank S. Alexander, \textit{Mortgage Prepayments: The Trial of Common Sense}, 72 CORNELL L. REV. 288 (1987) (Alexander’s article summarizes the topic of principal prepayment in mortgages and criticizes the \textit{Pedersen} decision and other similar decisions of the period that were based upon the pivotal nineteenth century case of \textit{Abbe v. Goodwin}, 7 Conn. 377 (1829). Alexander asserts that \textit{Abbe} misinterpreted the seventeenth century case, \textit{Talbot v. Bradill}, 23 Eng. Rep. 402 (Ch. 1683), \textit{aff’d on rehearing}, 23 Eng. Rep. 539 (Ch. 1689), citing the case as merely an exception to the rule of perfect tender in time. It should have cited the case as squarely representing the proposition that the debtor could propay the principal without penalty.).

\textsuperscript{148} Vicki A. Huffman, Annotation, \textit{Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortgagor to Prepay Principal Debt}, 86 A.L.R.3d 599, § 2a (1978).

\textsuperscript{149} \textit{CHG Int’l}, 897 F.2d at 1483.

\textsuperscript{150} \textit{Id.}
should not, the court adopted the language of *In re RDC Corp.*.\(^{151}\)

Trade Credit transactions are exactly that—a two way exchange. They further the policies of the code because *they allow the debtor to continue on in business and in the narrow context of ongoing trade exchange, they do not diminish the estate for it is replenished by the goods and services paid for.* A long term loan is an antecedent debt in the traditional sense. The monthly payments of interest do not represent ongoing trade transactions because the decision to pay them was made far in advance of the payment (at the time the loan was negotiated) and in fact nothing is exchanged at the time of the payments with the debtor which helps him to continue in business. There is merely an outflow of money from the estate.\(^{152}\)

Regarding the second part of this second issue, the appropriate judicial interpretation of congressional silence, the Ninth Circuit viewed congressional silence concerning the deletion of the 45-day restriction\(^{153}\) as indicating that Congress did not intend to shift significantly the policy behind the preference law, as would be the case if elimination of the 45-day restriction was allowed to open up the exception to long term debt.\(^{154}\) The Ninth Circuit viewed the elimination of the strict 45-day restriction as merely eliminating a source of irritation in the commercial paper and consumer lender markets and a source of constant litigation to determine exact obligation dates.\(^{155}\) The court asserted that the change was intended merely to add some flexibility as to what constituted the “trade credit” that would be entitled to the “ordinary course of business” exception.\(^{156}\) The court asserted that extending the exception to long term debt would create an exception that would practically swallow up the section 547(b) preferential transfer rule.\(^{157}\)

As noted earlier, the Supreme Court’s decision in *Wolas* was quite narrow. The Supreme Court was silent as to the first issue of determining when a borrower first becomes legally bound to pay interest. The Court was also silent as to the first part of the second issue of determining the meaning of “ordinary course of business.” It was only on the second part of the


\(^{152}\) *CHG Int'l*, 897 F.2d at 1485 (citing *In re RDC Corp.*, 88 B.R. at 99) (emphasis added).

\(^{153}\) There was no House or Senate Report submitted with the 1984 Bankruptcy Act legislation. The House Conference Report contained no mention of § 547(e)(2) and the Senate Conference Report contained only the brief exchange between Senators Dole and DeConcini alluded to previously. *See supra* note 60.

\(^{154}\) *CHG Int'l*, 897 F.2d at 1483-84.

\(^{155}\) *Id.* at 1484.

\(^{156}\) *Id.*

\(^{157}\) *Id.*
second issue, the appropriate judicial interpretation of congressional silence about its reason for amending a statute, that the Supreme Court ruled. The Court ruled that it was not permissible for the Ninth Circuit to construe from congressional silence that the Congress intended no substantial change in a law when a part of a statute is expressly deleted.158

Prior to the Supreme Court decision, not every court excluded, as a matter of law, interest payments on long term debt from the protection of section 547(c). In a case involving facts similar to CHG International,159 Fidelity Savings and Investment v. New Hope Baptist,160 the Tenth Circuit found that long term debt could be acquired in the “ordinary course of business,” and in this case was a necessary part of Fidelity’s business.161 The court found that such payments by Fidelity did not conflict with the bankruptcy policy behind the “ordinary course of business” exception162 to “leave undisturbed normal financial relations” of the debtor.163 The court concluded that while long term debt is not in the “ordinary course of business” for many types of businesses, it was in the ordinary course of business for Fidelity, and therefore entitled Fidelity to the “ordinary course of business” exception.164 The Tenth Circuit expressly rejected the position later adopted by the Ninth Circuit in CHG International and Wolas that the elimination of the 45-day restriction from section 547(c)(2) was done merely to eliminate an arbitrary restriction on trade credit.165 The Tenth Circuit adopted the position of an earlier Tenth Circuit case, Wilson v. Stocker,166 that determining a statute’s meaning must begin with the language of the statute itself.167 The Tenth Circuit found the statutory language did not limit section 547(c)(2) to trade credit, because the words “trade credit” were nowhere in the statute.168 The transaction merely had to comply with the

158. Wolas II, 112 S. Ct. at 533.
159. In this case the “loans” were savings certificates with maturities of 6 months to one year. The court found a close analogy to the commercial paper discussed in the Dole - DeConcini exchange alluded to supra note 60.
160. Fidelity Sav. & Invest., 880 F.2d 1172.
161. Id. at 1177.
162. Id.
164. Id. at 1177-78. The Tenth Circuit found support for its position in In re Control Electric, Inc., 91 B.R. 1010, 1011 (Bankr. N.D. Ga. 1988) (incurrence of long term loans could be considered within the ordinary course of business for a bank), and in In re Colonial Discount Corp., 807 F.2d 594 (7th Cir. 1986) (undertaking long term debt is an ordinary part of the real estate business).
165. Fidelity Sav. & Invest., 880 F.2d at 1175.
166. 819 F.2d 943 (10th Cir. 1987).
167. Id. at 948. “In determining the scope of a statute, the court must begin with the statutory language itself. When the terms of the statute are clear, the statutory language is controlling absent exceptional circumstances.” Id.
168. Fidelity Sav. & Invest., 880 F.2d at 1175.
three elements provided in the statute.\textsuperscript{169} The court also found that what little legislative history existed\textsuperscript{170} indicated that section 547(c)(2), as amended, was not intended to be limited only to trade credit.\textsuperscript{171} The Tenth Circuit's "plain language" approach relied upon \textit{U.S. v. Ron Pair Enterprises} where the Supreme Court held that a statute's plain language must control unless it is one of the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters."\textsuperscript{172}

\section*{V. Proposed Solution}

The key to determining whether long term debt or, more properly, longer term debt should be included in the "ordinary course of business" exception is whether the debt supports the regular or daily operations of the firm, or in the language of the Senate Report, "leaves undisturbed normal financial relations."\textsuperscript{173} The Ninth Circuit's adherence to a "quasi 45-day rule" is at odds with the plain meaning of the statute. The Tenth Circuit suggests a subjective test: Is the transaction in the "ordinary course of business" for that business? Furthermore, the Tenth Circuit limited the applicability of the exception to a period not to exceed one year.\textsuperscript{174} Though a step in the right direction, the subjective approach is incomplete. It does not address the adverse effect on general creditors of transfers that are "ordinary" for that particular business, but not "ordinary" for businesses of that type. An exclusively subjective approach would provide too much protection for transferees of rogue businesses (like ZZZZ, Best Inc., the debtor in the \textit{Wolas} case). Furthermore, the Tenth Circuit's one year limit is unnecessarily arbitrary.

DeSimone, in his excellent article, \textit{Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule},\textsuperscript{175} suggests that the test should be two-fold, with subjective and

\begin{enumerate}
\item\textsuperscript{169} \textit{Id.}
\item\textsuperscript{170} \textit{See supra} note 60.
\item\textsuperscript{171} \textit{Fidelity Sav. & Invest.}, 880 F.2d at 1175.
\item\textsuperscript{172} \textit{Ron Pair Enterprises}, 489 U.S. 235, 242 (citing Griffen v. Oceanic Contractors, Inc. 458 U.S. 564, 571 (1982)).
\item\textsuperscript{173} S.REP NO. 989, 95th Cong., 2d Sess. 88; This same idea, that the exception was intended to fund the daily operations of the business, operations that result in replenishing the assets of the debtor is expressed in both \textit{CHG Int'l}, 897 F.2d at 1485 and \textit{Fidelity Sav. & Invest.}, 880 F.2d at 1177. Their major difference seems to be how quickly the replenishment must take place in order to qualify for the exception. The Ninth Circuit in \textit{CHG International} seems unwilling to go much further than the 45 day restriction of the pre-amended version of the statute; The Tenth Circuit in \textit{Fidelity Savings} appears willing to entertain longer replenishment periods, at least up to a one year period.
\item\textsuperscript{174} The Tenth Circuit distanced itself from prior cases that held that payments made on debt with terms longer than one year were protected by the § 547(c)(2) exception. \textit{Fidelity Sav. & Invest.}, 880 F.2d at 1177.
\item\textsuperscript{175} DeSimone, \textit{supra} note 9, at 123-28.
\end{enumerate}
objective components. The subjective component of the test would correspond to the first two requirements of section 547(c)(2), testing whether the debt was incurred in the ordinary course of business and whether the payments were made in the ordinary course of business, for that business. DeSimone suggests that the best method to determine the subjective "ordinariness" of the transactions is to look at the past dealings of the parties. If there have been no past dealings between the particular parties, then the past dealings of the parties with other parties similarly situated should be examined. If the transaction meets the subjective requirement, it should then be examined under the lens of an objective requirement. This objective requirement is found in the language of the third element of section 547(c)(2), "made according to ordinary business terms." Here, the standard that DeSimone suggests is "general business practices." This objective test would preclude providing protection to some transactions no matter how "ordinary" they are to the parties.

The Desimone test provides an excellent method for examining and evaluating transfers but it leaves undefined "ordinary," the key word in the rule. The point of the "ordinary course of business" exception is to protect and support the ongoing business because payments made in the course of an ongoing business do not deplete the estate. To qualify as "ordinary," payments should support current operations and not capital expenditures or future operations. The time limit of the loan should be significant only as it contributes to understanding whether the loan is subjectively and objectively "ordinary"; that is, whether it subjectively and objectively supports current operations and not capital expenditures or future operations.

An additional two part test of "ordinariness" is thus suggested by the "current operations" standard. The two factors of this second test are (1) did the loan contribute directly to generating current revenue at the time the loan was made, and (2) was the loan contributing directly to generating current revenues at the time the interest payment in question was made. This form of analysis directly supports the two bankruptcy goals of equitable distribution and estate maximization. It also directly addresses the Senate Report desire to "leave undisturbed normal financial relations. . .".

The phrase "long term debt" has meaning only in the context of the

176. Id. at 125.
177. Id.
178. Id.
179. Id. at 126-27.
180. Id. at 126.
181. Id. at 127.
182. Id. at 124. This is particularly important in the Wolas case where the "regular business" of ZZZZ, Best Inc. was a "Ponzi scheme;" although "ordinary" for that business, it is unlikely that Congress wished to extend avoidance protection to fraudulent schemes. The "general business practice" test would neatly eliminate these types of transactions from consideration.
183. See supra note 173 and accompanying text.
parties involved. As the Congress clearly recognized, different enterprises have different credit cycles. Since the purpose of section 547(c)(2) is to permit troubled concerns to continue ordinary business operations by allowing extension of credit without fear of avoidance, it makes perfect sense to analyze the transaction in terms of the debtor’s and creditor’s business. An ordinary course transaction for a seller of sidewalk hotdogs is probably different from ordinary course transaction for a large defense contractor. Similarly, these two businesses will have substantially different credit cycles. The large defense contractor probably will not be able to continue its current operations if it is restricted to obtaining loans with terms of 45 days when the period between payments for its services may be a year or more. At the other extreme, the hotdog vendor probably has no need of longer term loans to support his daily operations, and therefore, any payments made by him to support longer term loans should be avoidable preferences and not allowed exemption status.

The two step test of DeSimone combined with the suggested two step test of “ordinariness” will provide the best method for treating such disparate businesses “equally.” The two step test of DeSimone tests whether the transfer was subjectively and objectively in the “ordinary” course of business. The additional two step test proposed by this Note defines “ordinary” by looking at whether the transfer directly contributed to current operations at the time the loan was made and at the time the interest payments in question were made. “Current operations” are defined as operations which directly contribute to current revenues. This “two plus two” step method best achieve the Bankruptcy Code goals of equitable treatment of creditors equally situated and maximizing the size of the remaining estate for the satisfaction of creditors.184

The facts of Wolas and CHG International, may be used to illustrate this “two plus two” step method. The Wolas case involved interest payments on an unsecured (or undersecured) eight-month revolving credit agreement. Applying the “two plus two” step method to Wolas would require first a determination of the length of loan required to support ordinary business operations for the general type of business and the particular business. But in Wolas, the debtor concern was a fraudulent organization with no ordinary course of business worthy of protection and continued operation.185 The Congress did not intend to protect and encourage continued operation of a fraudulent, illegal activity. Even if Wolas managed to pass the subjective and objective tests of DeSimone, it could not pass the additional tests suggested by this Note of requiring proof that the loans were used to generate current revenues at the time of the loan and at the time of each interest payment in question. Since this fraudulent operation generated no current revenues, it was not entitled to the “ordinary course of business”

184. These are the two bankruptcy goals described in Section I supra.
185. Wolas I, 921 F.2d at 969.
exception under the test proposed by this Note. The interest payments in question should be avoidable by the trustee.

In the case of CHG International, there is no simplifying fraudulent activity. The application of the “two plus two” step method of analysis would first determine whether the terms of the two loans in question were “ordinary” for that type of concern (real estate development) and typical for a commercial lender for that type of loan. If the two loans successfully pass the objective test, then the next step is to look at the terms of the loan for this particular debtor and creditor. If the transactions were consistent with prior dealings and not abnormal, and if they supported the current operations of the debtor (and no more) at the time of the loan and at the time of the payments in question, then the interest payments would be eligible for protection from avoidance. These facts were not in evidence, or at least not reported. The case, if appealed, should be remanded for a finding of facts on these questions.

The Ninth Circuit’s position that avoidability is tied directly to a specific, fixed time or loan term was unanimously rejected by the Supreme Court. This Note urges that loan terms alone do not discriminate well between loans that fulfill bankruptcy goals and loans that do not. The measure is too crude. It does not take into account the type of business involved and therefore poorly predicts the effect of those payments on the estate available to creditors. A more precise test is whether the loan is subjectively and objectively ordinary for that business and whether the loan supports current operations. Only current operations add assets to the estate in exchange for transfers within the time frame of concern to creditors of financially weak enterprises.

CONCLUSION

The Ninth Circuit’s adherence to a “quasi 45-day rule” added nothing to creditor predictability, was adverse to the “plain meaning” of the statute, and was unanimously rejected by the Supreme Court. Use of the suggested “two plus two” step method of analysis on Wolas would yield the same result reached by the Ninth Circuit but not for the same reason. In Wolas, the avoidance should be permitted because the transaction, in furtherance of a “Ponzi Scheme,” did not meet the requirements of section 547(c)(2)(C), “made according to ordinary business terms.” Even if it passed the two step test suggested by DeSimone, the loan in issue must fail the test for contribution to current revenues since this fraudulent pyramid scheme had no current operations and therefore, no current revenues. Application of the “two plus two” step method of analysis to CHG International would require the court to remand the case for a finding of fact on whether the transactions at issue were subjectively in the “ordinary course of business,” objectively

186. DeSimone, supra note 9, at 123-25.
“made according to ordinary business terms,” and whether the loans were used to support current operations at the time of the loan and when the payments in issue were made.

The effect of adopting the “two plus two” step method of analysis to all loan repayments would be to equalize the treatment of businesses with disparate credit cycles. Another effect of applying this method would be to increase the availability of credit and reduce the cost of credit to those business concerns whose credit cycles happen to substantially exceed 45 days. This would have the salutary effect of reducing the overall cost of bankruptcy to the economy by keeping “going concerns” in business. It would also benefit the particular creditors of those concerns by maximizing the size of the estate available to all creditors by reducing the rapid slide towards bankruptcy that generally results when a troubled concern is denied credit necessary to continue current operations.

Ken Magid*

* This Note I dedicate to my wife Gloria for her unfailing love; my daughter Elizabeth who at 3½ is wise beyond words; and my parents, Luis and Evelyn Lowenstein, whose support and encouragement have allowed me to return home from the sea.