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PANGLOSSIAN PREFERENCE PARADIGM?

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Introduction

On October 20, 1997, the National Bankruptcy Review Commission ("Commission") issued its long−awaited report, culminating two years of intensive study of the Bankruptcy Code. [1] The Commission was created by Congress in the Bankruptcy Reform Act of 1994. [2] The Commission was charged:

> (1) to investigate and study issues and problems relating to . . . the 'Bankruptcy Code'; (2) to evaluate the advisability of proposals and current arrangements with respect to those issues and problems; (3) to prepare and submit to Congress . . . a report in accordance with section 608; and (4) to solicit divergent views of all parties concerned with the operation of the bankruptcy system. [3]

Under the able leadership of Brady Williamson, Esq., as chair, [4] and Professor Elizabeth Warren, as Reporter and Consultant, [5] the Commission admirably carried out its statutory duties. In its last interim report filed in July 1997, the Commission stated that it held twenty meetings, heard from 2,900 parties by written or oral comments, listened to testimony from 270 witnesses, and welcomed 590 participants in working group and roundtable discussions. [6] Approximately 100 recommendations, touching almost every area of bankruptcy law, were adopted by the Commission. [7]

This article examines three of the Commission's proposals regarding bankruptcy preference law [8] and related provisions of the Judicial Code. [9] First, this article briefly reviews the conceptual underpinnings of bankruptcy preference law. Next, the results and recommendations of the 1997 American Bankruptcy Institute Preference Survey are discussed. [10] As will be explained below, these Survey results and recommendations arguably played a central role in influencing the Commission's own proposals. The next section presents the Commission's recommendations regarding bankruptcy preferences. Finally, this article argues that Congress should implement the proposals adopted by the Commission. While I do not suggest that preference law would be a Panglossian "best of all possible worlds" [11] if the suggested changes are made, adoption of the Commission's recommendations should help curb some serious abuses in preference practice today and enhance the clarity and fairness of that law. Panglossian, no, but preferable to present preference practice—absolutely.

I. The Reasons for Preference Law

Before looking at how the Commission proposes to change the bankruptcy preference law, it might be useful to review briefly what a preference is and what the purposes of the preference law are.

Most simply, "a preference is a transfer that favors one creditor over others." [12] But is that bad? At bottom, bankruptcy preference law exists because distributional schemes differ in and outside bankruptcy. [13] Outside of bankruptcy, [14] the operative paradigm is "first in time, first in right," also called "grab law." [15] Preferences in payment are perfectly permissible. [16] In bankruptcy, however, the distributional norm is equality among similarly situated creditors. [17] A basic problem of most bankruptcy cases is that the debtor has multiple creditors, and insufficient assets to pay them all in full. [18] The presumptive solution in bankruptcy is to deal with the creditors as a group and, absent good reason to give priority to any certain creditor, to accord pro rata treatment to all unsecured creditors. [19] Everyone shares the pain, and takes only their aliquot share, excepting the few statutorily favored creditors, who are given priority under section 507. [20]

The problem that preference law grapples with is making the transition from the nonbankruptcy "race" system, to the bankruptcy equality regime. [21] Prebankruptcy transfers of an insolvent debtor's property enable preferred creditors to recover more than their fair share of the debtor's insufficient pie − more than if the transfer had not been made. Preference law makes the preferred creditor throw the prebankruptcy transfer back into the pot, and share with everyone else. Without a preference recapture law, the bankruptcy distributional scheme could be subverted by transfers made on the eve of bankruptcy. [22] Little would be left for those creditors who were not fortunate or diligent enough to obtain a prebankruptcy preference. [23] This first justification for the preference law is referred to as the *equality* principle. [24] The bankruptcy norm of equality is extended back into the immediate prebankruptcy period. [25]

If equality were the only normative basis for the preference law, crafting that statutory law would be relatively simple. However, equality has never been the sole normative policy at work in the shaping of preference law. [26] From the earliest bankruptcy laws in late medieval England, a distinction has been drawn between permissible and impermissible preferences, between "good" and "bad" preferential transfers. [27] The fact that an insolvent debtor made a transfer to a creditor shortly before bankruptcy that would enable that creditor to fare better than its peers is not enough, standing alone, to warrant avoidance and recapture. [28] Stated otherwise, some prebankruptcy transfers that subvert equality between creditors may be allowed to stand. [29] For centuries, a creditor who simply got paid for an outstanding debt did nothing wrong, and in the interest of repose and justice, was allowed to keep the payment.

The $64,000 question is what constitutes the "plus" factor permitting recovery of a prebankruptcy preference, since the destruction of equality alone does not suffice. The historical development of preference law reveals that the key factor is whether the transfer was "normal" and was made in the "ordinary course." [30] Until the enactment of the 1978 Code, the "ordinary" question was cast in terms of the state of mind of either the debtor or the creditor. [31] For a very long time, bankruptcy law authorized the avoidance only of transfers made by the debtor with an intention to prefer a particular creditor. [32] In other words, the transfer would be voidable only if the debtor acted in contemplation of an obviously impending bankruptcy. A preference was viewed almost as a species of debtor fraud. [33]

Eventually, the need for creditor complicity in the preference became part of the avoidance equation; it became necessary to show that the creditor took the preference with "reasonable cause to believe the debtor was insolvent" at the time of the transfer. [34] Creditors, knowing that the debtor was in financial distress, would race to dismember the debtor, grabbing whatever assets they could, and consequently driving the debtor out of business and eliminating any chance for the troubled debtor to recover financially. [35] In order to deter such racing and to preserve the debtor's chances to stay in business, creditor knowledge had to be shown to avoid preferences. This requirement also sought to distinguish between "good" creditors and "bad" creditors, because "good" creditors, those without knowledge, would have no reason to race to grab the debtor's assets, and thus were not subject to recovery of preferences as are the "bad" creditors. [36]

Professor McCoid convincingly demonstrated, in a brilliant article, that the deterrence rationale for the preference law was "poppycock." [37] Even though there is a possibility of recapture of a preference, seeking the preference may still be to the creditors' advantage. [38] The only sanction for seeking a preference is that the "offending" creditor will have to give the money back with interest. [39] In other words, there is little reason for creditors not to take preferences, even if they know the debtor is insolvent.

One of the major reforms of the preference law in 1978 was to eliminate the "reasonable cause to believe" standard, because it was unworkable in practice and was irrelevant to the equality issue. However, equality still did not carry the day, deterrence did. Fault seems to be a difficult premise to shake; distributive justice does not appear to be as compelling. The ancient notion that some preferences are not "bad" and, thus, should be allowed to stand, found its way into the law in the ordinary course of business defense, in section 547(c)(2). [40] If a transfer is made in the "ordinary course," it is not an avoidable preference. [41] The drafters of the 1978 Code explained that an ordinary course transfer "does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." [42] Apparently, equality is left at the door. Allowing otherwise preferential transfers to remain valid just because they were "ordinary" undermines the idea that equality matters. [43] Thus, only if the transfer subverts equality *and* was made out of the ordinary course will the preference be avoidable. [44] Allowing normal and settled transactions to stand has carried the day.

In considering the Commission's preference recommendations, one must bear in mind the multiple purposes of the preference law, and the apparent subordination of the equality principle. I have suggested elsewhere that the *best* approach to preferences would be to accord primacy to the equality paradigm, and to repeal the ordinary course exception altogether. [45] That view, however, has not and apparently will not prevail. [46] People care primarily about culpability, and want to be free to carry on "business as usual." The idea that only abnormal prebankruptcy grabs should be avoidable, entrenched for several hundred years, apparently is here to stay. The question then is how best to shape the law to achieve the desired results.

II. Preference Survey Results

In 1995, the Unsecured Trade Creditor Committee of the American Bankruptcy Institute formed a twenty−seven member Task Force on Preferences. [47] The charge of this Task Force was to study the bankruptcy preference law to see if it was working, and how it might be improved. [48] There was strong sentiment that the preference law was not working as planned, [49] and winds of discontent with its operation were too strong to ignore. The Task Force had a very diverse representation, including attorneys, accountants, turnaround specialists, credit managers, and bankers. [50] Joseph S.U. Bodoff, Esq., of the law firm of Hinckley, Allen & Snyder in Boston, Massachusetts, chaired the Task Force. [51] To carry out its mission, the Task Force conducted a nationwide survey on the preference law in February 1997. [52] The results of the survey were reported and analyzed in the American Bankruptcy Institute's *Preference Survey Report ("Report")*, published in May 1997 as part of the ABI Bankruptcy Reform Study Project. [53] I had the privilege of serving as the Reporter for the Survey *Report*. [54]

Two surveys were prepared. Survey No. 1 was designed for credit providers—credit managers, lenders, and others involved in the business of providing credit. [55] Since these parties are among those most directly affected in practice by the preference law, either as (i) a possible preference defendant or (ii) a potential beneficiary of preferences recovered from other creditors, their perceptions of how well the preference law was working were of considerable value. [56] The second survey, Survey No. 2, was designed for bankruptcy practitioners—attorneys, accountants, trustees, and turnaround consultants. [57] The members of this second group, who actually deal with the implementation of the preference law, were able to provide useful insights into the operation of the law, and suggestions for reform. [58]

The *Report* contains several parts. Joseph Bodoff wrote a short introduction, describing the nature of the entire project. [59] Following was an article, "A History of Bankruptcy Preferences," [60] by Scott Blakeley, Esq., of the law firm of Blakeley & Brinkman in Los Angeles, California. The actual *Report* itself, which I wrote, begins with an Introduction, [61] then, in Part 2, states "General conclusions." [62] Part 3 contains a detailed "Discussion of responses," and comprises the largest portion of the report. [63] Part 4 then examines "Areas for Reform: Problems and Possible Solutions." [64] This fourth part, which served as the focus for subsequent discussions within the Working Group on Jurisdiction and Procedure of the National Bankruptcy Review Commission, made four "Recommendations" and nine "Other Ideas for Consideration." [65] The Recommendations are those proposals that garnered strong support in both the credit provider survey and the practitioner survey. [66] The "Other Ideas" drew support in the survey responses, but not as widespread as for the Recommendations. [67] The final section of the *Report* contained the actual questions and responses for both surveys. [68]

The "General conclusions" of the *Report* indicated that both sets of survey respondents "expressed skepticism as to whether the preference law is effectively achieving the two primary stated objectives of that law." [69] Significant concern also was expressed that "creditors who tried to work with debtors were penalized by the preference laws, and that those laws discouraged settlements and workouts." [70] Of the most direct relevance to the recommendations ultimately adopted by the Commission was the conclusion that "a widely−expressed criticism focused on the perceived coercive nature of many preference actions, with the preference defendant feeling pressured by economic and logistical concerns to settle claims of dubious validity." [71] Also relevant to the Commission's work was the view of the respondents that the ordinary course of business defense is unworkable. [72] The biggest problems noted are that no one knows what it means, and, not surprisingly in light of that perception, that application of the defense is inconsistent. [73]

In light of the responses, the *Report*, as noted above, made four Recommendations and suggested nine "Other Ideas for Consideration." [74] All three of the Commission's recommendations are taken from the *Report's* Recommendations and Other Ideas. Recommendation Number One in the *Report* was to *"Limit preference actions to cases involving a minimum dollar amount."* [75] Well over eighty percent of the respondents favored imposing a floor amount that must be in controversy before a preference avoidance action may be brought. [76] A majority of those respondents supported a floor amount of $5,000 (or higher). [77] Simply eliminating preference litigation over small amounts would be the most effective and direct way to curtail coercive and abusive preference litigation. [78]

A related abusive preference litigation tactic is to sue distant defendants in the bankruptcy home court. [79] The added cost of defending at a great distance places additional pressure on the defendant to settle even claims of dubious validity. [80] Accordingly, the thirteenth suggestion made in the *Report* was to "[a]*mend the venue rules to protect defendants from having to defend in a distant forum, at least when the amount in controversy is below a stated amount."* [81] The idea was to amend 28 U.S.C. § 1409 to increase the $1,000 amount under which a distant defendant on a nonconsumer debt is entitled to be sued in their home court. The ensuing discussion suggested combining the amendments to add a floor amount and to increase the venue amount, by "setting the minimum floor amount at one level, and permitting the preference action to be brought in the district where the case is pending only if the amount in controversy exceeds a higher amount." [82] The Commission ended up adopting exactly such a combination approach.

The final Recommendation made by the *Report* on which the Commission took action was Number Four: "*Clarify the ordinary course of business defense."* [83] As noted above, the most common suggestion voiced by the survey respondents was to do something to make the ordinary course defense easier to apply in practice. [84] The very uncertainty of that defense made litigation expensive and difficult.

III. The Commission's Recommendations

The members of the Jurisdiction and Procedure Working Group [85] of the National Bankruptcy Review Commission [86] met in May 1997 in Washington, D.C. with Joseph Bodoff, the chair of the ABI Task Force on Preferences, and with me, as the Reporter for the Preference Survey Report, as well as several other invited participants. The discussion focused on two major problems in preference litigation that the *Report* had identified, as discussed in the prior section. First, the coercive effect on trade creditor defendants of preference actions brought for relatively small dollar amounts; and second, the difficulty of applying the ordinary course of business defense. After substantial discussion of these issues, the Working Group agreed to recommend that the full Commission adopt three proposals relating to: (1) a threshold minimum dollar amount in business cases involving noninsider preference defendants; (2) a revised venue rule that would afford distant creditors the right to be sued in their "home court" for relatively small preference amounts; and (3) a clarification of the ordinary course of business defense.

In July 1997, the full Commission agreed with the Working Group's proposals, and voted to adopt the following three Recommendations:

> 3.2.1. *Minimum Amount to Commence a Preference Action under* 11 U.S.C. § 547
>
> 11 U.S.C. § 547 should provide that $5,000 is the minimum aggregate transfer to a noninsider creditor that must be sought in a nonconsumer debt preference avoidance action.
>
> 3.2.2. *Venue of Preference Actions under* 28 U.S.C. § 1409
>
> 28 U.S.C. § 1409 should be amended to require that a preference recovery action against a noninsider seeking less than $10,000 must be brought in the bankruptcy court in the district where the creditor has its principal place of business. The Recommendation applies to nonconsumer debts only.
>
> 3.2.3. *Ordinary Course of Business Exception under* 11 U.S.C. § 547(c)(2)(B)

> 11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test for whether a payment is made in the ordinary course of the debtor's business if it is made according to ordinary business terms. The ordinary course of business defense to a preference recovery action under section 547(c)(2) should provide as follows:
>
> > (2) to the extent that such transfer was 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 such transfer was—
> >
> > > (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
> > >
> > > (B) made according to ordinary business terms[.] [87]

The Commission's three preference law recommendations would change current law as follows:

First, the imposition of a $5,000 floor amount in business cases is entirely new. Currently, there is a $600 safe harbor in section 547(c)(8), but only in consumer cases. [88] The Commission recommendation apparently would leave that exception untouched.

Second, the venue rule in 28 U.S.C. § 1409(b) currently requires the trustee to sue a defendant in their home court (where they reside) if the amount in issue is less than $1,000, or $5,000 for consumer debts. [89] The recommendation would not change the $5,000 rule for consumer cases but, in business cases, would increase the home court right from a mere $1,000, at present, to $10,000. In conjunction with the $5,000 floor amount in business cases, the net effect of the first two proposals for preference defendants in business cases would be:

- an absolute exemption for amounts up to $5,000;
- for amounts from $5,000 up to $10,000, the right to be sued where the creditor has its principal place of business; and
- for amounts of $10,000 or more, the creditor could be sued where the bankruptcy case is pending.

Third, the revision of the ordinary course of business defense of section 547(c)(2) would change the conjunctive "and" between current subsection (c)(2)(B) and (C) to the disjunctive "or." The prevailing view in courts under the current law is that a preference defendant must prove *both* that the transfer was ordinary (i) subjectively, as between the debtor and the creditor, according to their past course of dealing, *and* (ii) objectively, judged by industry standards. [90] In other words, even if the transfer was ordinary as between this debtor and this creditor, the (c)(2) defense failed if the parties' past dealings deviated from the industry norm. The Commission recommendation would permit the creditor to prevail on a (c)(2) defense if it could show compliance *either* with the subjective course of dealings between the parties, without also having to show adherence to the industry standard, *or* compliance with the objective industry norm.

IV. In Praise of the Recommendations (Or, How I Learned to Stop Worrying and Love Preferences)

Preference law is a good idea in theory. It just does not work very well in practice. The respondents to the ABI Survey *Report* confirmed that fact. [91] Reconciling the often conflicting normative underpinnings of preference law is a particularly tricky proposition. The notion of distributive justice sounds appealing in the abstract, until creditors run up against the reality that it might be used against them. Preserving the sanctity of being able to carry on "business as usual" is, for most trade creditors, more important than promoting an idealized equality norm. The ordinary course of business defense, or something like it, is almost certainly here to stay; the fault−based notion of preference law has been around for hundreds of years, and few seem inclined to embrace a sea of changes in the basic conception of preference liability.

The problem, though, is that fault−based criteria are inherently fact−intensive and case−specific. That certainly is true in the preference litigation arena. A large percentage of preference litigation involving trade creditors focuses on the application of the ordinary course of business defense. And that application is uncertain both in terms of the facts and the law. The inevitable consequence is that preference litigation becomes more costly and outcomes more unpredictable. [92] Each side often can make a colorable argument that the payment of the debt *is* either in the ordinary course (the trade creditor's argument) or *is not* in the ordinary course (the trustee's argument). The trustee cannot count on being able to prevail in a preference action even when an insolvent debtor pays off an antecedent debt within the preference period—but neither can the trade creditor, who believes it was paid in the ordinary course, count on prevailing with an ordinary course defense. Summary judgment is extremely difficult for either side to come by. So what happens? Trustees can bring blanket preference actions against every unsecured creditor who got paid within the ninety days before bankruptcy, without bothering to investigate the "ordinariness" of any specific payment. Trade creditors can also throw up an ordinary course defense with equal impunity. In short, the vagueness of the ordinary course standard throws a wrench into the smooth operation of the preference laws, and bogs the system down into the mire of protracted litigation. Faced with that prospect, many smaller cases simply settle, often splitting the difference, with little regard to the merits of the case.

The Commission's three recommendations attempt to cut the Gordian knot of the preference morass by using two simple strategies. The first recommendation is to eliminate all small preference litigation in business cases. Imposing a $5,000 floor amount accomplishes this task. One of the biggest complaints voiced by the trade creditors in the Survey *Report* was that they felt pressured to settle small cases, [93] even if they felt they had a meritorious defense, because it would cost more to defend and win a lawsuit than to settle with the trustee. Once the amount in controversy increases, however, the complaint becomes less compelling. A trade creditor who is sued for a $25,000 preference payment will find it worthwhile to litigate, and is not likely to settle, whereas a creditor who is sued for $800 might well settle even if the creditor had a valid defense.

The recommended amendment to the venue rule in 28 U.S.C. § 1409 is supported on almost identical grounds. A creditor who is hauled into court halfway across the country on relatively small amounts would be strongly inclined to settle. If that creditor, however, is permitted to litigate where it has its principal place of business in suits seeking less than $10,000, the coercive threat is reduced. The effect is that for suits between $5,000 and $10,000, the creditor is entitled to litigate at home, but does not have the absolute immunity from suit that it would have for amounts of less than $5,000. Once the amount gets over $10,000, the creditor can hardly complain at having to litigate in a distant forum.

The second recommendation of the Commission's preference strategy is to clarify and simplify the "ordinary course" defense. Since that defense is the leading cause of most preference litigation uncertainty, clarification should help reduce the costs of litigation and enhance the predictability of outcomes. Under the Commission's proposal, the trade creditor would prevail if it could establish *either* that it complied with the parties' prior course of dealings *or* with the prevailing industry standard. [94] The benefit derived as a result, for most trade creditors, is that it will free them from having to address the industry standard, which is the big stumbling block. [95] Identifying the relevant industry, and ascertaining what the norm is in that industry, can be very difficult. If the parties have a well−established history, the creditor could establish the ordinary course defense simply by showing: (i) what the prior practice was and (ii) that the challenged payments fell within that past practice. In most situations, showing what the payment terms and history had been should be relatively straight forward. For example, if the debtor had been paying the creditor within forty to fifty days after invoice for a couple of years, and the payments made in the preference period were made in the forty to fifty day range, the creditor should prevail. Importantly, this type of fact inquiry should be amenable to summary judgment. Furthermore, the costs of litigating for both the creditor and the bankruptcy estate should decrease.

But do these recommendations signal a partial death knell for preference law as we know it? Sure. But so what? The *Report* results show that the preference law is not working well right now. [96] As things stand, one could make a cogent argument that the whole preference system is not "worth the candle." There is much sound and fury, signifying almost nothing—except to generate a lot of fees for trustees and lawyers. One possible alternative would be to repeal the preference law entirely. [97] But that approach would open up the possibility of large−scale preferences, which would (i) subvert and preempt the bankruptcy distributional scheme, [98] and (ii) foster a debilitating "race to the courthouse" when a debtor is in financial distress. Another alternative would be to make preference recoveries more absolute, eliminating the ordinary course defense, [99] and recovering virtually all transfers made during the preference period. However, that approach would run counter to the overriding impulse of business people, which is to carry on normal business transactions, and to expect finality and repose of settled transactions. [100]

The Commission's Recommendations mark a sensible, second−best, pragmatic solution to the preference conundrum. For relatively small business preference cases, the preference law is in effect repealed. [101] It is just not worth fighting over small sums. The damage to preference policy is not too great. Equality is not seriously compromised by allowing transfers of less than $5,000 to stand, [102] and only in very small preference cases would a "race to the courthouse" over amounts of less than $5,000 risk driving the debtor out of business. But for larger amounts, it is worth spending the time and money necessary to promote equality [103] and preserve the bankruptcy distributional scheme, [104] and to try to reduce the incentive for creditors to resort to grab law.

Increasing the "home court" venue rule to bring an action from $1,000 to $10,000 will adversely impact the bankruptcy estate's ability and willingness to pursue distant creditors. The added cost and inconvenience to the trustee might deter the trustee from pursuing some claims between $5,000 and $10,000. The question for Congress to consider is simply whether this cost is worth the benefit of treating remote creditors more fairly. It is worth noting that the concomitant Recommendation to simplify the ordinary course defense should make preference litigation less complex, by reducing the cost of preference litigation, and thus making it less of a problem for the trustee to litigate elsewhere. [105]

One should note that neither of the two dollar−amount recommendations apply to (i) insiders or (ii) consumer cases. Insiders who receive a preference must face the full fury of the preference law, without exemption, and without home court venue rights. [106] Furthermore, the proposed changes will apply only to business cases. [107]

The Commission's Recommendation to clarify the ordinary course of business defense so that a creditor needs only to prove compliance with the course of dealing between the parties should be welcomed by almost everyone. This change would make the ordinary course defense much easier to prove, by increasing certainty and reducing cost. [108] The only concern is that allowing deviation from industry norms, as the proposal would, may result in an increase in "special deals" favoring one creditor over others. In theory, a debtor and a powerful creditor could manipulate their prepetition conduct to insulate the creditor from the threat of subsequent bankruptcy preference recoveries. [109] Requiring adherence to an industry standard tends to minimize the possibility of such machinations and objectifies the assessment of the "normalcy" of the dealings. These speculative concerns, however, hardly seem to outweigh the very real and concrete harm suffered by the demanding case−by−case proof of industry terms. Further, it must be remembered that the creditor must be able to prove that the past dealings were sufficient to rise to the level of a course of dealing.

Indeed, an argument could be made that the goal of encouraging creditors to work with a financially troubled debtor would be promoted if individual creditors were permitted to establish more permissive payment terms for the debtor, and yet remain aloof from a preference threat. [110] To illustrate this point, as matters now stand, a creditor in an industry in which payment was made within thirty days would be at serious risk if it took payments regularly at forty−five days. Even if that creditor and the debtor had a well established history to prove a forty−five day subjective norm, the creditor could not prove compliance with the thirty day industry practice. But the debtor who is given more time to pay by a few creditors, should have a greater chance of resuscitating its business. The Commission's proposal would afford them that chance.

In conclusion, the preference recommendations made by the Commission may not be a Panglossian solution viewed from the standpoint of theoretical and conceptual purity, but bankruptcy happens in the real world. The idea of recapturing transfers on the eve−of−bankruptcy by insolvent debtors, for the benefit of the creditor body, while innately appealing as a distributional norm, runs into seemingly intractable practical problems when applied to small transfers. In such cases, eliminating the preference option altogether may be the most practical solution. And in all other cases, where the dollar amount is worth litigating over, the need for a clearer bright−line rule can be met by allowing creditors to escape liability by proving compliance with their past course of dealings with the debtor.

FOOTNOTES:

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[1] *See generally* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report (1997) [hereinafter Commission Report].Back To Text

[2] Bankruptcy Reform Act of 1994, Pub. L. No. 103−394, § 602, 108 Stat. 4147.Back To Text

[3] *See generally* id. § 608 (requiring Commission submit detailed statement of findings, conclusions, and recommendations no later than two years after first meeting).Back To Text

[4] *See* Commission Report, supra note 1, at i. Representative Mike Synar, the original chair of the Commission, died in January 1996 and was succeeded by Brady Williamson.Back To Text

[5] *See* id. at 1.Back To Text

[6] *See* id. at 65 (excluding 8/11/97 totals, 591 participants, 278 at Open Forum, and 2722 attendees).Back To Text

[7] *See generally* id. at 1−1028 (detailing various recommendations).Back To Text

[8] *See* 11 U.S.C. § 547 (1994).Back To Text

[9] *See* 11 U.S.C. § 1409.Back To Text

[10] *See* Joseph S.U. Bodoff, *Bankruptcy Reform Study Project: The ABI Preference Survey* (Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencefront.html>. In the interest of full disclosure, the author of this article confesses that he served as the Reporter for the ABI Preference Survey. Having said that, the views expressed in this article are not necessarily the official views of the American Bankruptcy Institute, but are those of the author alone.Back To Text

[11] *See* Voltaire, Candide 18 (1959) (writing that Candide's tutor Pangloss "proved admirably that in this best of all possible worlds . . . things cannot be otherwise: for, since everything was made for a purpose, everything is necessarily for the best purpose").Back To Text

[12] Charles Jordan Tabb, The Law of Bankruptcy, § 6.7 at 348 (1997) [hereinafter Tabb, Bankruptcy]. Back To Text

[13] *See* Charles Jordan Tabb, Rethinking Preferences, 43 S.C. L. Rev. 981, 987−88 (1992) (stating that inside bankruptcy creditors get pro rata treatment and share same priority claim, whereas outside of bankruptcy, whoever levies on debtor's assets first, wins and gets paid before other creditors). Back To Text

[14] *See* Thomas H. Jackson, *Avoiding Powers in* Bankruptcy, 36 Stan. L. Rev. 725, 757 (1984) (noting that reasons why preferences are generally permitted outside bankruptcy are obvious); Tabb, supra note 13, at 988 (acknowledging that outside of bankruptcy, preferences are not considered inherently evil).Back To Text

[15] *See, e.g.,* Jackson, supra note 14, at 758 (stating that outside of bankruptcy, creditors race for debtors assets to prevent being left with nothing); Tabb, supra note 13, at 988 (stating that operative paradigm outside of bankruptcy is "first in time is first in right," which creates race of diligence and grabbing among creditors).Back To Text

[16] *See* Tabb, supra note 13, at 988 (noting "[o]utside of bankruptcy . . . a preference is not considered inherently evil"); Jackson, supra note 14, at 757 (stating preferences are generally permissible outside of bankruptcy).Back To Text

[17] *See* Jackson, supra note 14, at 728 (stating that creditors share ratably in debtor's assets); Tabb, supra note 13, at 987 (explaining that "[e]quality . . . means the pro rata treatment of creditors who share the same priority claim to the debtor's assets").Back To Text

[18] *See* Jackson, supra note 14, at 728 (noting that when debtor does not have enough to pay everyone in full, bankruptcy constrains creditors from promoting individual interests).Back To Text

[19] *See* supra note 17 and accompanying text.Back To Text

[20] 11 U.S.C. § 547 (1994). Back To Text

[21] *See* Jackson, supra note 14, at 758−59 (explaining that creditors agree to pro rata distribution before they lend money but race for assets once debtor becomes insolvent creating need for enforcement mechanism, such as collective proceeding, to create equality); Tabb, supra note 13, at 989−90 (noting that when creditors see collective proceeding looming, they race to grab what they can, making actual equality difficult to achieve).Back To Text

[22] *See* Vern Countryman, *The Concept of a Voidable Preference in* Bankruptcy, 38 Vand. L. Rev. 713, 748 (1985) (noting legislative intent for equality of distribution).Back To Text

[23] *See* Tabb, supra note 13, at 987 (showing example of two creditors and result of one obtaining preference). Back To Text

[24] *See* Tabb, supra note 13, at 987 (stating equality means pro rata treatment of creditors who share same priority claims to debtor's assets).Back To Text

[25] *See* id. at 1000 (stating English doctrine of preferences did include recapture provision).Back To Text

[26] *See* Tabb, supra note 13, at 987 (noting that deterrence and equality are two predominate rationales for preference law). Back To Text

[27] *See* Tabb, supra note 13, at 995 (stating that "[t]he distinction between good and bad preferences appears to have originated in the middle of the eighteenth century in England"); *see generally* John C. McCoid, II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 Va. L. Rev. 249, 250 (1981) (stating that preferences and fraudulent conveyances are different, however, preference law is closely tied to early English bankruptcy law). Back To Text

[28] *See* Tabb, supra note 13, at 982−83 (stating that although creditors may be treated unequally, this is not sufficient to place transaction in either good or bad category). *See generally* McCoid, supra note 27, at 262 (discussing effectiveness of recapture).Back To Text

[29] *See* 11 U.S.C. § 547(c)(2) (establishing ordinary course of business exception).Back To Text

[30] *See* Tabb, supra note 13, at 983 (determining avoidance of preference dependent upon whether it was normal or in ordinary course of business).Back To Text

[31] *See* Countryman, supra note 22, at 718 (explaining roots of intent element as prevailing in English courts); Tabb, supra note 13, at 1001−1003 (stating that intent rule from England was adopted in American courts and eventually enacted in Bankruptcy Act of 1841).Back To Text

[32] *See* Tabb, Bankruptcy, supra note 12, § 6.7 at 350.Back To Text

[33] *See* Jackson, supra note 14, at 772 (stating that preference laws prevented creditor from exercising redemption rights once in bankruptcy).Back To Text

[34] *See* Tabb, supra note 13, at 1006 (stating that Bankruptcy Act of 1867 created requirement that creditor have "reasonable cause to believe" that debtor was insolvent at time of transfer).Back To Text

[35] *See* Jackson, supra note 14, at 759 (stating that creditors who knew of debtors inevitable insolvency attempted to receive payments prior to bankruptcy to avoid being placed in parity with other unsecured creditors). Back To Text

[36] *See* id. (noting that "reasonable cause to believe" requirement was created solely to prevent only creditor with knowledge from receiving preference).Back To Text

[37] *See* McCoid, supra note 27, at 263−65 (stating that only people deterred are those who know of debtor's situation and that sanctions imposed by law are not significant enough to stop debtor from seeking preference).Back To Text

[38] *See* McCoid, supra note 27, at 264. The author explains that a preference might not be subject to recapture because the bankruptcy may never be filed, or not filed within the ninety days after transfer. *See* id. Even if it is recaptured, the asset in the creditor's hands for that period may have produced income greater than that owed under the recapture. *See* id. Back To Text

[39] *See* id.Back To Text

[40] 11 U.S.C. § 547(c)(2) (1994). *See* Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.), 78 F.3d 30, 41 (2d Cir. 1996) (stating that ordinary business exception protects creditors who "remain committed to the creditor" during debtor's financial difficulties).Back To Text

[41] *See* 11 U.S.C. § 547(c)(2). In section 547(c)(2), the criteria of the ordinary course of business exception is established. *See* id. The trustee cannot avoid a transfer if it 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; (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." *See* id. Back To Text

[42] S. Rep. No. 95−989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; H.R. Rep. No. 95−595, at 373 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6329.Back To Text

[43] *See* Jackson, supra note 14, at 775−76 (explaining that some of ordinary payments may still place debtor into bankruptcy creating inequality among creditors).Back To Text

[44] *See* 11 U.S.C. § 547(c)(2) (1994). Back To Text

[45] *See* Tabb, supra note 13, at 983−85.Back To Text

[46] *See* id. at 994−95 (stating that despite valid explanations pertaining to repeal of reasonable cause to believe standard "deterrence ultimately is given primacy over equality via ordinary course of business exception").Back To Text

[47] *See* Bodoff, supra note 10.Back To Text

[48] *See* id.Back To Text

[49] *See* id.Back To Text

[50] *See* id. (acknowledging Andrew J. Sutherland, Bank of America Illinois, Chicago, Illinois; Loretta R. Cross, Coopers & Lybrand LLP, Houston, Texas; Lloyd B. Saraking, Sony Electronics Inc., Park Ridge, New Jersey, et al.).Back To Text

[51] *See* id.Back To Text

[52] *See* Bodoff, supra note 10.Back To Text

[53] *See* id.Back To Text

[54] *See* id.Back To Text

[55] Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#intro>.Back To Text

[56] *See* id.Back To Text

[57] *See* id.Back To Text

[58] *See* id.Back To Text

[59] *See* Bodoff, supra note 10.Back To Text

[60] Scott Blakeley, Esq., *A History of Bankruptcy Preferences* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preference/blakeley.html> (discussing history of preference law, starting with development of preference law in England, leading into American Bankruptcy law, where preference was developed in early 1800's and ending with 1984 Bankruptcy Amendments).Back To Text

[61] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#intro>.Back To Text

[62] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#general>.Back To Text

[63] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#discussion1>.Back To Text

[64] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#reform>.Back To Text

[65] *See* id.Back To Text

[66] *See* id.Back To Text

[67] *See* id.Back To Text

[68] *See* id.Back To Text

[69] Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#reform>.Back To Text

[70] Id.Back To Text

[71] Id.Back To Text

[72] *See* id.Back To Text

[73] *See* id.Back To Text

[74] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#reform>.Back To Text

[75] Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#recomm1>.Back To Text

[76] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey/chartfive.html>.Back To Text

[77] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#recomm1>.Back To Text

[78] *See* id.Back To Text

[79] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#recomm3>.Back To Text

[80] *See* id.Back To Text

[81] Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#recomm13>.Back To Text

[82] Id. Back To Text

[83] Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#recomm4>.Back To Text

[84] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#reform>. Back To Text

[85] The members who were present were Judge Edith Jones and Jeffrey J. Hartley, Esq., along with senior advisor, Professor Lawrence P. King.Back To Text

[86] *See* Commission Report, supra note 1, at 47 (noting that National Bankruptcy Review Commission was established by Bankruptcy Reform Act of 1994).Back To Text

[87] Id.Back To Text

[88] *See* 11 U.S.C. § 547(c)(8) (1994).Back To Text

[89] *See* 28 U.S.C. § 1409(b) (1994).Back To Text

[90] *See, e.g.,* Lawson v. Ford Motor Co. (In re Roblin Indus.), 78 F.3d 30, 38−39 (2d Cir. 1996) (discussing elements of ordinary course of business transfers).Back To Text

[91] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#general>. The respondents "expressed skepticism as to whether the preference law is effectively achieving the two primary stated objectives of that law. Furthermore, respondents thought the creditors who tried to work with debtors were penalized by the preference laws, and that the laws discouraged settlement and workouts." Id. Respondent responses to survey questions and their criticisms of the preference laws can be found on the internet on the bankruptcy library of the American Bankruptcy Institute's website. *See* id.Back To Text

[92] *See* Tabb, supra note 13, at 993. Back To Text

[93] *See* American Bankruptcy Institute, Task Force on Preferences, *Bankruptcy Reform Study Project − ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencefront .html>. The

respondents of the survey were given an opportunity to express their own opinion in certain questions. Question S1−18 of the creditor survey asked, "What one specific area of existing preference law most troubles you, and what should be done to resolve this issue?" Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Prefernce Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#discussion14>. A response suggested that there is pressure to settle small cases and the recommended solution posed to the problem was to impose a floor dollar amount on preference suits. *See* id. Back To Text

[94] *See* supra notes 91−99 and accompanying text (discussing Recommendations of Commission, specifically proposal 14, ordinary course of business defense).Back To Text

[95] *See* Lawson v. Ford Motor Corp. (In re Roblin Indus.), 78 F.3d 30, 42 (2d Cir. 1996) (stating that ordinary course of business defense as it would apply to trade creditor also includes burden of proving that industry standard was met). Back To Text

[96] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#discussion14>. In response to the survey question as discussed in note 93, the primary concern was the ordinary course of business defense in section 547(c)(2). The respondents concluded "this defense is not working well in practice." Id. The two problems are that no one knows the meaning of section 547(c)(2), and this leads to inconsistent results. *See* id. Secondly, the respondents do not believe that the defense affords sufficiently broad protection. *See* id. As recommendations to solving the problem, the respondents suggest to either clarify the meaning of the defense or to set "bright−line rules and safe harbors." Id. Back To Text

[97] *See* McCoid, supra note 27, at 260 (citing reasons why abolishing preference law will be effective alternative to achieving ultimate goal of bankruptcy, equality of distribution and maximization of estate value).Back To Text

[98] *See* id. (stating overall bankruptcy scheme is for equal distribution of debtor's assets).Back To Text

[99] *See* Tabb, supra note 13, at 983−86 (stating that ordinary course of business exception "undercuts the proper basis of preference liability" and also that as long as section 547(c)(2) is still in Bankruptcy Code in its current form, "it is difficult to justify having preference law at all"); *see also* Countryman, *supra* note 22, at 776 (concluding that "in view of the feeble inspiration for this exception, and because the exception is completely at war with the concept of a preference and has no rational confining limits, the best future for the present section is repeal").Back To Text

[100] *See* McCoid, supra note 27, at 259−60 (explaining how every creditor in normal daily activity expects to be paid because of independent dealing with debtor).Back To Text

[101] *See* supra note 93 and accompanying text.Back To Text

[102] *See* Tabb, supra note 13, at 988 (stating that "[r]ewarding the more diligent creditors by permitting them to keep the assets that they obtained might be justified as economically efficient . . . ").Back To Text

[103] *See id.* at 987 (defining equality as pro rata treatment of creditors who share same priority claim to debtor's assets).Back To Text

[104] *See* McCoid, supra note 27, at 260; *see also* supra note 22 and accompanying text.Back To Text

[105] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html # recomm 12 and 13>. The survey indicated that preference litigation often is "unfairly coercive" and that preference actions are threatened or brought against distant defendants for small dollar amounts with very little or no investigation of the "merits of the action." Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferencesurvey.html#discussion14>. Possible solutions and recommendations offered by the respondents to cure this problem included: a) changing the law and requiring losers

to pay other side's fees and costs; b) amending the venue rules so preference defendants could not be subject to suit in a distant forum. *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/ legis/reform/preferencesurvey.html#recomm12 and 13 >.Back To Text

[106] *See* Charles Jordan Tabb, *Bankruptcy Reform Study Project: The ABI Preference Survey* (visited Oct. 23, 1997) <http://www.abiworld.org/legis/reform/preferncesurvey.html#recomm12 and 13>.Back To Text

[107] *See* id.Back To Text

[108] *See* supra note 90 and accompanying text.Back To Text

[109] *See, e.g.,* McCoid, supra note 27, at 252−53. The author cites decision reported by Sir Edward Coke, The Case of Bankrupts, 76 Eng. Rep. 441, 473 (K.B. 1584), where Lord Coke stated, "[I]f after, the debtor becomes a bankrupt, he may prefer one (who per adventure hath least need) and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a great defect in the law." Id. McCoid cites this case to bring out attention to the fact that a preference can be closely linked to fraud. *See* id. In other words fraudulent conduct on the part of the debtor and creditor may serve to insulate creditor from postbankrupcty preference recoveries. Back To Text

[110] *See* Tabb, supra note 13, at 1021. The ordinary course safe harbor can be characterized as "creating or preserving an incentive for creditors to extend credit to distressed debtors." Id. Tabb suggests that from this provision, the debtor may be kept out of a bankruptcy entirely, which will make the creditor, other creditors and the debtor all better off. *See* id. *Back To Text*