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Rethinking Preferences

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RETHINKING PREFERENCES

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I. INTRODUCTION

The conventional wisdom is, and long has been, that there are

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good preferences and bad preferences, with only the latter subject to avoidance and recapture.[1] Over two hundred years ago Lord Mansfield observed, "A general question has been started, whether a man may or may not, at the eve of a bankruptcy, give a preference to a particular creditor? *I think he may, and he may not.*"[2] In a speech given shortly after the enactment of the Bankruptcy Act of 1898, Referee Morris Wise observed, "Consequently in providing for the prohibition of preferences, Congress has, at all times, in the history of the Bankruptcy legislation of the country, carefully endeavored to preserve a distinction between what may be termed guilty and innocent preferences."[3]

The bankruptcy law in the United States today follows the conventional wisdom and permits only the avoidance of preferences of the bad variety.[4] A preference neutered from the adjoining denomination of good or bad refers simply to the transfer of property of an insolvent

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1. *See, e.g.*, C. Robert Morris, Jr., *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 738-39 (1970). Professor Morris stated that "[t]he bad preference . . . is one which involves some element of culpability." *Id.* at 739.

Although Professor Morris wrote before the major 1978 bankruptcy law revision, which supposedly placed the preference law on a more objective basis and reduced the emphasis on culpability, *see infra* notes 48-50, 52-53, 217 and accompanying text, the view that he presented has not passed from the scene. For example, Professor-Dean-Provost Jackson asserts that "preference law is a creditor misbehavior rule." THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 126 n.8 (1986) (emphasis omitted). He published an earlier article, Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 756-77 (1984), the cited portion of which largely comprises chapter 6 of his book. For cites that appear in both the article and the book, this Article will cite to the book.

Avoidance of a preference is governed by 11 U.S.C. § 547; recapture is governed by 11 U.S.C. § 550.

2. Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768) (emphasis added). He added, "If one demands it first, or sues him, or threatens him, without fraud, the preference is good. But where it is manifestly to defeat the law, it is bad." *Id.*

The English view still is that a preference given in response to creditor pressure is valid. *See* John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 252 (1981). The current bankruptcy law in the United States has moved away from this approach. Such a preference would meet all of the elements of 11 U.S.C. § 547(b) and would not be a transfer in the ordinary course of business under 11 U.S.C. § 547(c)(2).

3. Morris S. Wise, *Preferences: Guilty or Innocent*, Address Before the Annual Meeting of the Nat'l Ass'n of Referees in Bankruptcy (Aug. 30, 1900), *in* 2 NAT'L BANKR. NEWS & REP., Oct. 1, 1900, at 7.

4. 11 U.S.C. § 547 (1988). The Bankruptcy Code is found in Title 11 of the United States Code and is referred to herein as the "Code" or "Bankruptcy Code." It was enacted on November 6, 1978, in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, and governs bankruptcy cases filed on or after October 1, 1979. The law applicable to cases filed prior to October 1, 1979 is known as and will be referred to herein as the "Bankruptcy Act" or "Act." Act of Dec. 20, 1950, ch. 1138, 64 Stat. 1113.

debtor to one of its creditors shortly before the debtor goes into bankruptcy, thus enabling that creditor to receive more than it would have otherwise.[5] The essential attribute of such a transfer is that one creditor gets paid and others do not.[6] Creditors are treated unequally, at a time when the debtor was insolvent.

Under the conventional wisdom, however, this fact standing alone is not enough to cast the transaction into the ultimate categories of good or bad—or, more specifically, to determine whether the transaction is avoidable. What, then, is the decisive factor that determines the avoidability of the transaction, whether that transfer falls on the good or bad side of the line? One answer, which has been expressed and implemented in a variety of ways over the past two and one-half centuries,[7] is that payments made to creditors in the ordinary course of business and trade are permitted. Payments made outside of that ordinary course of business, on the other hand, are much more likely to be avoided.

This Article challenges the conventional wisdom. My thesis is that

5. Professor Douglas Baird defined preferences as "eve-of-bankruptcy transfers to creditors that distort bankruptcy's pro rata sharing rule." DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 155 (1992); *see also* Elizabeth A. Orelup, Note, *Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978*, 65 IOWA L. REV. 209, 209 (1979).

The elements of an avoidable preference are detailed in 11 U.S.C. § 547(b). Under that subsection the bankruptcy trustee must prove, 11 U.S.C. § 547(g) (1988):

(1) a transfer, *id.* § 547(b); *see id.* § 101(54) (Supp. II 1990);

(2) of the debtor's property, *id.* § 547(b) (1988); *see id.* § 541 (1988 & Supp. II 1990);

(3) to or for the benefit of a creditor, *id.* § 547(b)(1) (1988); *see id.* § 101(10) (Supp. II 1990);

(4) for an antecedent debt, *id.* § 547(b)(2) (1988);

(5) while the debtor was insolvent, *id.* § 547(b)(3); *see id.* § 101(32) (Supp. II 1990);

(6) during the preference period, *id.* § 547(b)(4) (1988); and

(7) which enables the creditor to receive more than it would have in a Chapter 7 case if the transfer had not been made, *id.* § 547(b)(5), *i.e.*, the transfer has a preferential effect.

Insolvency is presumed for the 90 days before bankruptcy, *id.* § 547(f), thus making the trustee's proof substantially easier. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 178 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138-39 [hereinafter HOUSE REPORT].

The preference period is 90 days, 11 U.S.C. § 547(b)(4)(A) (1988), except for insiders, for whom a one-year reach back is utilized, *id.* § 547(b)(4)(B).

If the trustee proves the elements of a preference under § 547(b), the creditor then has the opportunity to prove that one or more of the exceptions of § 547(c) protect it from preference avoidance. One of those safe harbors, § 547(c)(2), is the focus of this Article.

6. *See* JACKSON, *supra* note 1, at 123.

7. *See* An Act for Amending the Laws Relating to Bankrupts, 1746, 19 Geo. 2, ch. 32, § 1 (Eng.); *see infra* notes 67-68, 70-72 and accompanying text.

many of the currently protected good preferences should be made subject to avoidance and recapture.[8] Specifically, I advocate the repeal of the ordinary course of business exception in section 547(c)(2) of the Bankruptcy Code.[9] That section undercuts the proper basis of prefer-

8. My concern is with the application of the preference law to *unsecured* creditors. Issues relating to secured creditors, such as the optimal way to deal with the floating lien, *see* 11 U.S.C. § 547(c)(5) (1988), and the proper treatment of enabling loans, *id.* § 547(c)(3), raise very different problems, and are beyond the scope of this Article.

9. 11 U.S.C. § 547(c)(2) (1988). I therefore second the suggestion of Professor Vern Countryman, who in his inimitable style concluded, "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 present section 547(c)(2) is repeal." Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 776 (1985) (footnote omitted). In his overall conclusion to the article, he repeated this view in equally emphatic language. *Id.* at 817.

The basic idea is not a new one. Over fifty years ago Referee F.W. Thomas suggested repealing the requirement that a preference could be recovered only if the creditor had reasonable cause to believe that the debtor was insolvent, found in § 60b of the 1898 Act, as amended by the Chandler Act, ch. 575, § 60b, 52 Stat. 840, 870 (1938) (repealed 1978). *See infra* part III(C). The major premise was that "a preference is a preference." Paul H. King, *Proposed Amendments to the Chandler Act*, 45 COM. L.J. 36, 41 (1940). Referee Thomas's suggestion was put forward in a speech by Paul King, then chairman of the National Bankruptcy Conference, who himself added that "the suggestion has force." *Id.*

Although Congress in 1978 did repeal the reasonable cause to believe test, *see infra* notes 49-53, 217 and accompanying text, the introduction of the ordinary course exception in § 547(c)(2) has essentially led to many of the same difficulties that existed with the reasonable cause test. *See* Darrell Dunham & Donald Price, *The End of Preference Liability for Unsecured Creditors: New Section 547(c)(2) of the Bankruptcy Code*, 60 IND. L.J. 487, 512 (1985).

A note published soon after the enactment of the 1978 Code stated, "If not narrowly construed, the 'ordinary course' exception could provide a loophole that would significantly weaken the entire structure of preference law." Orelup, *supra* note 5, at 236. Courts and Congress have ignored this caveat, and the prediction made has come true.

Another commentator writing shortly after the Code's passage predicted accurately that the "exception will likely emerge as a popular defense against a trustee's preference action, thereby succeeding the widely used 'reasonable cause to believe' defense under the Act." Morris W. Macey, *Preferences and Fraudulent Transfers Under the Bankruptcy Reform Act of 1978*, 28 EMORY L.J. 685, 693 (1979).

I also support, in part, the views of Professor Lissa Broome. In her article, Lissa L. Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 DUKE L.J. 78, she argued for a restrictive interpretation of § 547(c)(2) that would exclude payments on long-term debt from the scope of that subsection. *Id.* at 82. Unfortunately, the Supreme Court rejected her position in Union Bank v. Wolas, 112 S. Ct. 527 (1991).

I go beyond the position advocated by Professor Broome, however, and argue for the repeal of § 547(c)(2) altogether. She seems to accept the incentive effect rationale for that subsection. Broome, *supra*, at 117-20; *see infra* part IV(C)(1). The *Wolas* decision eliminated Broome's approach as an alternative, making the course that I recommend more of a necessity for those who believe that the equality paradigm should predominate in the framing of preference law.

ence liability. As long as section 547(c)(2) remains on the books in its current form, it is difficult to justify having a preference law at all.

The wisdom and necessity of repeal have been heightened by the Supreme Court's December 1991 decision in *Union Bank v. Wolas*.[10] In *Wolas* the Court held that section 547(c)(2) can apply to shield payments on long-term debt from preference recovery.[11] This holding was not surprising, given the elimination of the forty-five day rule from section 547(c)(2) in 1984[12] and the Supreme Court's recent proclivity to

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10. 112 S. Ct. 527 (1991). The case was well known by the name "*ZZZZ Best*" before the Supreme Court decision. ZZZZ Best Co., Inc. was the name of the debtor and thus also the style of the Ninth Circuit decision that excluded payments on long-term debt. Wolas v. Union Bank (*In re* ZZZZ Best Co.), 921 F.2d 968 (9th Cir. 1990), *rev'd sub nom.* Union Bank v. Wolas, 112 S. Ct. 527 (1991). Recognizing, however, that future discussion of this issue will focus on the Supreme Court decision, this Article will refer to the case as *Wolas* (the name of the trustee who brought the preference action).

The Ninth Circuit's decision in *Wolas* was a one-page per curiam opinion that relied on the circuit's earlier decision in CHG International, Inc. v. Barclays Bank (*In re* CHG International, Inc.), 897 F.2d 1479 (9th Cir. 1990). The *CHG International* opinion by Judge Hall examined the arguments for and against the application of § 547(c)(2) to payments on long-term debt and determined that these payments were not protected by that subsection.

The Sixth Circuit had held in Gosch v. Burns (*In re* Finn), 909 F.2d 903 (6th Cir. 1990), that § 547(c)(2) could be applied to long-term debt. The Sixth Circuit relied heavily on the plain language of that subsection after the 1984 amendment that deleted the 45-day limitation. The Supreme Court's decision in *Wolas* took a similar approach to that of the Sixth Circuit.

The bases for the Court's decision in *Wolas* also were presented in an article published just before the Court's decision was handed down. *See* Barkley Clark, *Scheduled Debt Payments as Preferences: Paradigm of the Plain Meaning Rule*, 1 J. BANKR. L. & PRAC. 7 (1991). Clark argued that the Ninth Circuit's approach was wrong on nearly every conceivable ground. Although I serve on the Editorial Advisory Board of the Journal in which Clark's article was published, I respectfully must disagree with the position that he takes. Other commentators also favored the view that the subsection should apply to payments on long-term debt. *See, e.g.*, David J. DeSimone, *Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule*, 20 AKRON L. REV. 95, 129-31 (1986).

My sympathies lie much more closely with the views of Professor Lissa Broome, as reflected in her excellent article, *see supra* note 9. Professor Broome argued that § 547(c)(2) should not be applied to long-term debt. *Id.* at 82.

11. *Wolas*, 112 S. Ct. at 533.

12. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 462(c), § 547(c)(2), 98 Stat. 333, 378. *See infra* notes 228-30 and accompanying text.

One article published shortly after the 1984 amendments suggested that "even a slightly expansive reading of new section 547(c)(2) may have the practical effect of eliminating preference liability for almost all payments to unsecured creditors." Dunham & Price, *supra* note 9, at 500. However, the authors more optimistically suggested that "[t]here are good reasons for believing that Congress did not intend to totally emasculate the preference section." *Id.*

plain meaning holdings.[13] At this juncture, repeal of section 547(c)(2) may be the only viable way to forestall the virtually complete evisceration of the equality purpose of preference law[14] that is threatened by the 1984 amendments and the *Wolas* decision.

This assumes that equality is in fact a primary goal of preference law. Under *Wolas* the goal of preserving "normal financial relations"[15] swallows up any realistic supposition that equality matters. My view that section 547(c)(2) deserves the fate of repeal predated *Wolas*, however, and stands independently of that decision.

Part II of the Article analyzes the principal policies of preference law—equality and deterrence—and asserts that equality should be given precedence. Part III details the historical development of the ordinary course safe harbor. In Part IV the Article explicates and criticizes the justifications for the ordinary course exception. Finally, Part V assesses the ramifications of repealing section 547(c)(2) and concludes by arguing for that change in the law.

II. PURPOSES OF PREFERENCE LAW: THE PRIMACY OF EQUALITY OVER DETERRENCE

To set the stage, consider a simple example. Assume that there is a debtor *D* who has three trade creditors, imaginatively named *A*, *B*, and *C*. Assume further that *D* owes each creditor $600 and that each debt was incurred in the ordinary course of business. *D*, however, only has $900 in assets. *D* therefore is insolvent within the meaning of the Bankruptcy Code.[16] The day before *D* files a Chapter 11 case, *D* pays creditor *A* in full, on ordinary business terms and during the normal trade cycle (assume thirty days). *D* retains the other $300 to use in the Chapter 11 case. Neither creditor *B* nor *C* is paid anything. Assume that the Chapter 11 case fails (having consumed the last $300 of the debtor's assets) and that the case is converted to Chapter 7. The trustee then sues creditor A to recover the preferential payment.

Two ultimate results are possible. One is to let *A* keep the money. This means that *A* would receive $600, and *B* and *C* would receive nothing. The second is to make *A* give the money back. Then, the $600

13. *See* Charles J. Tabb & Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823, 879-81 (1992).

14. *See* HOUSE REPORT, *supra* note 5, at 177-78; *infra* part II.

15. *See* HOUSE REPORT, *supra* note 5, at 373; *infra* part II.

16. 11 U.S.C. § 101(32)(A) (Supp. II 1990) ("[T]he sum of such entity's debts is greater than all of such entity's property, at a fair valuation."). This is the balance sheet test. In the hypothetical the debtor also would be insolvent in the equity sense of inability to pay its debts as they come due.

would be distributed equally to *A*, *B*, and *C*, or $200 each. Preference law is about making a choice between these two alternatives. To make that choice requires the identification of the purposes that underlie preference law.

Two rationales for preference law predominate: equality and deterrence.[17] The latter is sometimes cast in terms of the result supposedly achieved by deterrence—namely maximization of the value of the debtor's assets.[18] These two policy goals conflict at times[19]—as in the case of an ordinary course transfer shortly before bankruptcy. The distinction between good and bad preferences follows naturally from the identification of deterrence as the predominant purpose of preference law. I assert that equality instead should be given ascendancy, and that doing so leads to the conclusion that section 547(c)(2) should be repealed.

Equality in this context means the pro rata treatment of creditors who share the same priority claim to the debtor's assets.[20] These are the unsecured, nonpriority creditors. Secured creditors command higher priority rights in their specific collateral than general creditors under nonbankruptcy law, and this priority is theoretically honored by bankruptcy law generally and by preference law specifically.[21] Priority creditors are unsecured creditors who, for a variety of policy reasons, are paid before general creditors pursuant to section 507(a).[22]

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17. *See* HOUSE REPORT, *supra* note 5, at 177-78.

18. *See* McCoid, *supra* note 2, at 261; Bruce R. Kraus, Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449, 1450 (1978).

19. *See* Union Bank v. Wolas, 112 S. Ct. 527, 533 (1991).

20. *See* Raymond T. Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L. REV. 289, 292 (1980); Charles Seligson, *Preferences Under the Bankruptcy Act*, 15 VAND. L. REV. 115, 115 (1961).

Professor Countryman quibbled that "no bankruptcy policy of 'equality' exists," pointing out that creditors are classified based on liens and priorities. Countryman, *supra* note 9, at 748; *see* Morris, *supra* note 1, at 738. Professor Countryman concluded that "[t]he function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution." Countryman, *supra* note 9, at 748.

Professor Countryman, as is usually the case, was correct. However, for similarly situated creditors, the controlling bankruptcy distribution concept is equal treatment on a pro rata basis. *See, e.g.*, 11 U.S.C. §§ 726(b), 1123(a)(4), 1322(a)(3) (1988). For convenience, in this Article I use the term "equality" to describe in a shorthand way "the bankruptcy policy of distribution."

21. A preference does not occur when a fully secured creditor gets paid because the transfer does not enable the creditor to receive more than it would have in a Chapter 7 bankruptcy proceeding if the transfer had not been made. Thus, § 547(b)(5) is not satisfied. *See* Barash v. Public Fin. Corp., 658 F.2d 504, 508 (7th Cir. 1981).

22. 11 U.S.C. § 507(a) (1988 & Supp. II 1990). The priorities are strictly statutory. 3 COLLIER ON BANKRUPTCY ¶ 507.02[2], at 507-11 (Lawrence P. King et al. eds., 15th ed. 1991).

Outside of bankruptcy, unsecured creditors do not have a right to an aliquot share of the debtor's unencumbered assets. Rather, the defining characteristic of nonbankruptcy collection law is the race of diligence—"first in time is first in right."[23] The creditor who first obtains a writ of execution and has the sheriff levy on the debtor's assets, or who first garnishes the debtor's bank account, wins and gets paid before less diligent creditors. Outside of a collective proceeding, then, a preference is not considered inherently evil.[24]

This view is predicated, however, on the implicit assumption that the debtor is solvent, *i.e.*, that all creditors eventually will be paid in full. If that assumption fails and the debtor is instead insolvent, the fairness of a preference becomes much more questionable. In the event of insolvency the payment of one creditor necessarily means not only that other creditors will not get paid in full, but also that they will not even receive a pro rata share of the debtor's already insufficient assets.[25]

This result by itself does not necessarily require the conclusion that a preference is a bad thing, even following insolvency. In theory, in advance of anyone being paid, all creditors have an equal shot at winning the race of diligence. Rewarding the more diligent creditors by permitting them to keep the assets that they obtained might be justified as economically efficient, or under the equitable maxim that equity rewards the vigilant.

One problem with this view is that the underlying assumption that all creditors have an equal shot at winning the race is flawed. Some creditors will have superior information about the prospects of the debtor's impending insolvency, or better ability to move quickly to grab the debtor's assets.[26] In earlier times the practical advantage in collecting that local creditors held over more distant creditors was seen as providing a need for a preference recapture law.[27] Otherwise, the extension of credit by geographically removed creditors would be chilled to the detriment of the economy. Still other creditors are more likely to be paid first because the debtor wants to do so: the creditor

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23. DAVID G. EPSTEIN ET AL., DEBTORS AND CREDITORS: CASES AND MATERIALS 9 (3d ed. 1987); Richard I. Aaron, *The Bankruptcy Reform Act of 1978: The Full-Employment-for-Lawyers Bill* (pt. 4—Avoiding Powers of the Trustee), 1980 UTAH L. REV. 19, 20.

24. *See* BAIRD, *supra* note 5, at 156; JACKSON, *supra* note 1, at 124.

25. *See* Aaron, *supra* note 23, at 38; McCoid, *supra* note 2, at 260; Charles Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U. L. REV. 292, 293 (1967).

26. *See* JACKSON, *supra* note 1, at 125.

27. *See* James A. McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 234 (1946).

may be a relative, or a business associate, or someone with whom the debtor anticipates future dealings.[28]

Another basic problem exists with the argument that favors upholding preferences made after the onset of insolvency. Doing so is inconsistent with the fundamental tenet of equality of distribution that undergirds a bankruptcy or other collective proceeding that deals with an insolvent debtor.[29] In a collective proceeding equality replaces the nonbankruptcy law premise of race as the defining principle. This result may be justified on "common pool" grounds,[30] or on the fundamental premise that "equality is equity."[31] Whatever the rationale, the model of equality *in* the collective proceeding unquestionably controls.

Saying that equality prevails *in* a collective proceeding does not necessarily demand the conclusion that a like premise should be extended into the time period *before* the collective proceeding begins.[32] Many of the problems in casting preference law stem from the difficulty of making the transition from the nonbankruptcy race paradigm to the bankruptcy equality model. If insolvency and the collective proceeding (*e.g.*, bankruptcy) occurred at the same instant, preference law would be unnecessary.[33] The race model, which may be justifiable for a solvent debtor, would continue until insolvency occurred. At that juncture equality would take over in the context of the collective proceeding.

However, this convenient theoretical ordering of things does not exist in real life. Insolvency almost always occurs before the collective proceeding is commenced. Some creditors are paid during this transition period. Once the existence of a transition period between the onset of insolvency and the commencement of a collective proceeding is recognized, the need for choosing between the race and equality paradigms arises.

The opt out theory, which is advanced primarily by Professors Baird[34] and Jackson,[35] suggests a means for making that choice. This theory assumes that some creditors may see the collective proceeding coming before it actually occurs. Given this window of opportunity,

28. *See* McCoid, *supra* note 2, at 260 n.75.

29. *See id.* at 260-61.

30. JACKSON, *supra* note 1, at 125-26.

31. 2 JOHN N. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE §§ 405-412, at 144-59 (5th ed. 1941); *see* Orelup, *supra* note 5, at 212 n.30. Professor Charles Seligson stated the maxim the other way: "Equity is equality." Seligson, *supra* note 20, at 115.

32. *See* Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 BUS. LAW. 175, 180 (1985).

33. *See* JACKSON, *supra* note 1, at 124-25.

34. BAIRD, *supra* note 5, at 156.

35. JACKSON, *supra* note 1, at 124-26.

when the race model is still apparently in effect, but with equality looming, it is only natural that those who see what is coming should try to avoid its consequences and obtain a personal advantage.[36] The personal advantage obtained is, however, contrary to the interests of the creditor group as a whole. Thus, a way to restrain individual pursuit of self-interest is needed.[37]

The deterrence rationale therefore becomes important. The argument is that if preference law reaches back to recapture payments made during this transition period, in which insolvency has occurred but the collective proceeding has not yet been commenced, creditors will be deterred from taking advantage of their superior knowledge. As the argument goes, there is no advantage to be gained; therefore, it is wasteful to engage in the collection process. Deterring parties who do see the collective proceeding on the horizon from racing to grab the debtor's assets theoretically will help the debtor stay in business[38] and thereby increase the asset pool available for all creditors as a group.

Deterrence is effective, however, only against parties who are aware of the debtor's financial distress and who therefore see the collective proceeding coming. Innocent parties by definition will not be deterred; the state of the preference law will have no impact on their behavior. The logical leap that is then made is that recapture should not be extended to these innocent parties because they would not be deterred anyway. Apparently, for those lucky innocent creditors the race model continues to apply until the actual commencement of the collective proceeding.

I submit that the operative paradigm during the transition period between the advent of insolvency and the filing of the bankruptcy proceeding should be equality, not race. Whether preferred creditors knowingly opted out or were just lucky should not be relevant to whether they get to keep the preferential payment. Given this conclusion, section 547(c)(2) loses much of its significance. The essential premise of a race-based collection system is the debtor's solvency. Once insolvency is presumed, the race model loses its validity.

The foregoing argument for making deterrence the operative premise of preference law must withstand the initial criticism that deterrence does not work. A decade ago Professor McCoid questioned the deterrent effect of preference law[39]; many others have agreed with

36. *See id.* at 124.

37. *See* Kraus, *supra* note 18, at 1453-54.

38. *See* HOUSE REPORT, *supra* note 5, at 177; Union Bank v. Wolas, 112 S. Ct. 527, 533 (1991).

39. *See* McCoid, *supra* note 2, at 263-65.

him.[40] An economically rational creditor usually will decide to take a preference. The only sanction of the bankruptcy preference law is that the preferred creditor has to return the money paid,[41] thereby returning to the status that it had before receipt of the preferential transfer. The creditor then will receive the bankruptcy distribution that it would have gotten without the preference. The only potentially lost costs are those associated with receiving the preference in the first place—for example, sheriff's fees and attorneys fees—and with defending a preference lawsuit, if the creditor chooses to do so.[42]

If recapture were absolutely certain, then deterrence might work, given these transaction costs. However, recapture is not a certainty, and the prudent creditor will discount that likelihood accordingly. First, ninety-one days may elapse before the debtor files bankruptcy, in which case the preference is secure unless the creditor is an insider.[43] Second, even if the debtor goes into bankruptcy within ninety days, the trustee may not bring a preference action against the creditor. Third, even if the trustee brings a preference action, the creditor may prevail. Section 547(c)(2) further weakens the deterrence rationale by making it much more likely that the preferred creditor will be allowed to keep the preference.

The potential negative consequence that taking a preference may drive the debtor out of business, thereby causing a possible loss on other claims that the creditor might have against the debtor, or a loss of future business, has no independent value because of bankruptcy preference law. That risk would be the same even if there were no preference law or indeed no bankruptcy law. In theory, then, deterrence should not work. Moreover, deterrence does not work in practice and experience suggests that economic theory does work.

Furthermore, even if deterrence did serve to halt or at least slow the race of diligence, giving deterrence precedence over equality still would not be warranted. A basic notion of equity jurisprudence, apart from the strictures of any particular bankruptcy law, is that the unen-

40. *See, e.g.*, Countryman, *supra* note 9, at 748; Kraus, *supra* note 18, at 1458; Nimmer, *supra* note 20, at 292 n.9; *see also* Michael J. Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 696 (1983) ("[R]ationale is largely meaningless."). At least Professor Herbert did not discriminate between policies. He went on to say, "The second rationale, equality of distribution, is more complex although perhaps equally meaningless." *Id.*

41. *See* 11 U.S.C. § 550 (1988).

42. *See* JACKSON, *supra* note 1, at 138. The creditor presumably will make a cost-benefit analysis at the time of the suit to decide whether to defend or not. Therefore, except for the costs that are connected with making that decision, it would not be proper to add in any lawsuit costs with regard to the initial decision whether to take the preference.

43. 11 U.S.C. § 547(b)(4) (1988).

cumbered assets of an *insolvent* debtor are held in trust for the benefit of the entire body of unsecured creditors. After insolvency occurs those creditors are the equitable owners of the debtor's assets, with their ownership shares determined on a pro rata basis.

In a sense, then, a creditor who receives more than its pro rata share of the debtor's assets after the debtor becomes insolvent has taken property that equitably belongs to other creditors. If we feel the need to ascribe some sense of moral blameworthiness to the preferred creditor in order to justify disturbing the repose of settled transactions,[44] then this basic fact should suffice. Note that the harm is accomplished even if the recipient is entirely innocent of any complicitous mens rea. An analogy may be made to the law of conversion, which holds even an innocent converter liable for the value of the property converted.

One also could question whether even a supposedly innocent creditor really is so innocent, or whether in most cases the trustee simply cannot prove that opt out behavior nevertheless is taking place. Much the same problem existed with the old "reasonable cause to believe" test. In every case some reason must explain why a few creditors are preferred; preferences rarely occur by accident.

Along similar lines, we will see later that the ordinary course exception is often justified by the supposed normalcy of the transaction. However, one may challenge the implicit assumption that *any* transfer made by an *insolvent* debtor can be said to be in the ordinary course of business. In the eyes of the commercial world, upon the occurrence of insolvency the debtor has moved into a new, high risk category. Any creditor who knows of the debtor's insolvency will make financial decisions regarding that debtor on an entirely different basis than for a solvent debtor.[45] The heightened risk cannot be ignored.

Even more fundamentally, however, the unstated premise of the deterrence rationale is that culpability somehow matters and that innocence should therefore be rewarded. More than anything else, preference theory needs to shake off this antiquated morality notion and embrace instead the equality principle. The 1977 House Report discussed below almost made this step, but unfortunately slipped, almost inadvertently, back into the same old culpability game.

Concepts from early English bankruptcy law support the model of "equality after insolvency" as the appropriate paradigm. In bank-

44. Professor Herbert cautioned against framing a preference policy on the basis of "unanalyzed piety." Herbert, *supra* note 40, at 695. While perhaps my approach is in some respects pietistic, at least I do not think that it is "unanalyzed."

45. Professor Herbert questioned whether § 547(c)(2) was even workable for this reason. *Id.* at 692-94.

ruptcy, pro rata distribution was, as it is now, the norm. However, the English measured the operative time of the bankruptcy from when an act of bankruptcy was committed, which predated the actual commencement of the bankruptcy proceeding.[46] Such an act of bankruptcy signaled the debtor's insolvency.

We do not extend equality all the way back to the onset of insolvency, although that has been proposed.[47] The reason not to do so, however, has nothing to do with the merits of the opt out argument, or any deficiency in the equality principle. Rather, the independent policy of repose in commercial transactions is effectuated by the ninety day limitation in section 547(b)(4)(A). Within the ninety day period, when repose is not given full effect, we should give equality primacy.

A preference rule favoring equality would be simpler and easier to administer. Difficult issues regarding what is in the ordinary course and the like, which promote so much costly litigation, would be eliminated. Furthermore, and somewhat paradoxically, adopting a more absolute equality rule would further deterrence by increasing the likelihood of recapture.

The tension between the policies of equality and deterrence is evidenced starkly by the 1977 House Report, which accompanied an earlier version of the bill that eventually became the Bankruptcy Reform Act of 1978. That Report first appeared to establish equality of distribution as the unquestioned preeminent goal:

> The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, *and more important*, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge it so that all may share equally. The operation of the preference section to deter the "race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section—that of equality of distribution.[48]

The House Report further explained that this very primacy of the

46. *See* Garrard Glenn, *The Diversities of the Preferential Transfer: A Study in Bankruptcy History*, 15 CORNELL L.Q. 521, 528 (1930); *see infra* note 63 and accompanying text.

47. *See* Kraus, *supra* note 18, at 1459-60.

48. HOUSE REPORT, *supra* note 5, at 177-78 (emphasis added).

equality policy necessitated the repeal of the Act's requirement that preferences could be recaptured only if the trustee proved that the creditor had reasonable cause to believe that the debtor was insolvent at the time the transfer was made.[49]

> This provision [reasonable cause to believe that the debtor was insolvent] was designed when the primary purpose of the preference section was to prevent the race of diligence. Whether or not a creditor knows or believes that his debtor is sliding into bankruptcy is important if the only purpose of the preference section is to deter the race. However, a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors.[50]

As a normative matter I agree with the arguments just quoted from the House Report. Equality is fairer and more equitable, it is more efficient, it makes more logical sense, and it is simpler and easier to administer than fault-based theories of preference recovery. Unfortunately, the above passages were not all that the House Report had to say about preferences, and the Bankruptcy Code as enacted was not true to the paradigm described in those excerpts. Rather, the ordinary course safe harbor enacted as section 547(c)(2) undermines the equality principle, as discussed more fully below. The House Report justified section 547(c)(2) as follows:

> The second exception protects ordinary course of business . . . transfers. . . . The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.[51]

In reading this explanation, one is left to wonder what happened to the "strong bankruptcy policy of equality," of which absolutely no mention is made. Instead, section 547(c)(2) is rationalized entirely on the deterrence principle, which the same Report had earlier described as secondary to equality. Regardless, the net effect is that, despite the

49. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, § 60b, 30 Stat. 544, 562 (1898) (repealed 1978) [hereinafter Bankruptcy Act of 1898]; *see infra* notes 169-78, 180-81 and accompanying text.

50. HOUSE REPORT, *supra* note 5, at 178.

51. *Id.* at 373.

protestations to the contrary accompanying the explanation of the repeal of the reasonable cause to believe standard, deterrence ultimately is given primacy over equality via the ordinary course of business exception.

Yet, it is unlikely that Congress intended to effect such a result. As Part III will show, the ordinary course exception must be understood in light of the historical background against which it was enacted. That background shows a fairly clear intention to *narrow* the scope of protection given to certain creditors and to promote more strongly the equality goal.[52] Richard Levin, one of the drafters of the 1978 Code, stated that "[t]he goal of equality of distribution among creditors becomes paramount," thereby reversing the situation from that obtained under the Bankruptcy Act, in which "this goal was secondary to Congress' desire to preserve transactions that occur in the ordinary course of business."[53] It is to that historical background that I now turn.

III. HISTORICAL DEVELOPMENT OF THE ORDINARY COURSE SAFE HARBOR

A. *Early English Bankruptcy Preference Law*

The distinction between good and bad preferences appears to have originated in the middle of the eighteenth century in England. The first English bankruptcy law, 34 & 35 Henry 8, chapter 4 in 1542,[54] specified pro rata distribution of the bankrupt's assets to creditors.[55] That law did not specifically proscribe the giving of preferences, however.[56] The 1570 Statute of 13 Elizabeth,[57] the first comprehensive English bankruptcy statute,[58] likewise commanded pro rata distribution, but was silent on preferences.

As early as 1584, the making of a postbankruptcy preference was denounced judicially by Lord Coke in *The Case of Bankrupts (Smith*

52. *See* Thomas M. Ward & Jay A. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U. L.Q. 1, 17-18 (1983).

53. Richard B. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 184 (1979).

54. An Act Against Such Persons as Do Make Bankrupts, 1542, 34 & 35 Hen. 8, ch. 4 (Eng.); *see* Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 329 & n.21 (1991).

55. An Act Against Such Persons as Do Make Bankrupts, 1542, 34 & 35 Hen. 8, ch. 4, § 1 (Eng.).

56. *See* Countryman, *supra* note 9, at 715.

57. 13 Eliz., ch. 7, § 2 (1570) (Eng.).

58. *See* Tabb, *supra* note 54, at 329 n.21.

v. Mills).[59] Although in one sense the case is of limited value as a foundation stone of preference law, since it did not involve a prebankruptcy transfer to a creditor, it still bears mention because of some of the broader language used. On February 21, John Cook, the bankrupt, transferred twenty-four pounds of his property in partial satisfaction of a sixty-four pound debt to one creditor, Robert Tibnam. However, four days earlier, on February 17, the Lord Chancellor had granted a bankruptcy commission in response to a petition filed by several creditors on February 12. When the commissioners sold the same goods, a dispute over those goods arose. The holding was that the sale of the commissioners was good and that the transfer by Cook to Tibnam was void.[60]

Lord Coke first stated the overriding principle of equal distribution:

> So that the intent of the makers of the said Act [13 Eliz., chapter 7], expressed in plain words, was to relieve the creditors of the bankrupt equally, and that there should be an equal and rateable proportion observed in the distribution of the bankrupt's goods amongst the creditors, having regard to the quantity of their several debts . . . .[61]

He then extended that principle to distributions that the debtor made after becoming bankrupt and before the actual commencement of the bankruptcy proceeding: "[T]here ought to be an equal distribution . . . ; but if, after the debtor becomes a bankrupt, he may prefer one . . . 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 . . . ."[62]

Under English law a debtor became a bankrupt upon the commission of an act of bankruptcy, which predated (and indeed was the prerequisite to) the actual commencement of the bankruptcy proceeding and the appointment of the bankruptcy commissioners. The bankruptcy commissioners' title related back to the time of the act of bankruptcy and voided transfers made by the debtor after that date.[63]

In 1623 the Statute of 21 James 1[64] appeared to make the giving of a fraudulent preference (although the word "preference" was not used) a criminal offense, for which the bankrupt would be pilloried for two hours and have an ear cut off. The statute required that the conveyance be fraudulent or deceitful, in the amount of twenty pounds or

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59. 76 Eng. Rep. 441 (K.B. 1584).
60. *Id.* at 441-58.
61. *Id.* at 464-68.
62. *Id.* at 473.
63. 2 WILLIAM BLACKSTONE, COMMENTARIES *486.
64. 21 Jam. 1, ch. 19, § 7 (1623) (Eng.).

more, and "to the end and purpose to hinder the execution of this statute."[65] The focus, then, was on the intent of the debtor. This statute did not provide for avoidance and recapture of the preference, however, but only imposed criminal liability.[66]

One cornerstone of the distinction between good and bad preferences was laid in 1746 in the Statute of 19 George 2.[67] The preamble to that statute indicated that then, as now, the distinction rested largely on the perceived necessity of protecting ordinary course business transactions involving creditors who were unaware of the debtor's financial difficulties.[68] That statute created a safe harbor for creditors who the debtor paid in the ordinary course of trade *after* the commission of an act of bankruptcy but *before* the issuing of a bankruptcy commission. Under the relation back doctrine, this was at that time the period of vulnerability, although Lord Mansfield soon was to extend the creditor's exposure into the time period immediately preceding the commission of the act of bankruptcy.[69]

The elements that had to be established for the creditor to come within the statutory protection, which bear a striking resemblance in some respects to section 547(c)(2) of the Code and in others to the reasonable cause to believe test of section 60b of the 1898 Act, were: (1) the claim had to arise in a bona fide credit transaction and in the ordinary course of trade,[70] (2) the payment had to be made in the ordi-

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65. *Id.*

66. *In re* Hall, 4 Am. Bankr. Rep. 671, 679 (W.D.N.Y. 1900).

67. 19 Geo. 2, ch. 32, § 1 (1746) (Eng.); *see Hall*, 4 Am. Bankr. Rep. at 682-83.

68. 19 Geo. 2, ch. 32, § 1 (1746) (Eng.). The preamble stated:

> WHEREAS many persons within the description of, and liable to the statutes concerning bankrupts, frequently commit secret acts of bankruptcy unknown to their creditors and other persons, with whom, in the course of trade, they have dealings and transactions; and after the committing thereof, continue to appear publickly and carry on their trade and dealings, by buying and selling of goods and merchandizes, drawing, accepting, and negociating bills of exchange, and paying and receiving money on account thereof, in the usual way of trade, and in the same open and publick manner as if they were solvent persons, and had not become bankrupt; and whereas the permitting such secret acts of bankruptcy to avoid and defeat payments, really and *bona fide* made in the cases, and under the circumstances above mentioned, where the persons receiving the same had not notice of, or were privy to such persons having committed any act of bankruptcy, will be a great discouragement to trade and commerce, and a prejudice to credit in general.

Id.

69. *See infra* notes 75-76 and accompanying text.

70. 19 Geo. 2, ch. 32, § 1 (1746) (Eng.). The statute stated:

> [N]o person who is or shall be really and *bona fide* a creditor of any bankrupt, for or in respect of goods really and *bona fide* sold to such bankrupt, or for or in respect of any bill or bills of exchange really and *bona fide* drawn, negotiated, or accepted by such bankrupt, in the usual and ordinary course of trade

nary course of trade,[71] and (3) the creditor had to not know or have notice that the debtor at the time was bankrupt or in insolvent circumstances.[72] Blackstone observed that this statute puts the law "upon a more reasonable footing" and that "it would be prejudicial to trade to carry this notion [of postbankruptcy recapture] to its utmost length."[73]

The preference recapture rule, as well as the exception just stated, addressed only the time period after the commission of an act of bankruptcy by the debtor. As noted above, this predated the actual filing of a bankruptcy petition and the granting of the commission, of which there was public notice, but nonetheless came after the onset of bankruptcy. Thus, with the exception of one isolated decision in 1680,[74] the law did not address the situation of a creditor who was preferred *before* even the commission of an act of bankruptcy. However, Lord Mansfield soon filled this gap.

In the 1758 case of *Worsley v. Demattos*,[75] Lord Mansfield stated in dictum that a transfer of all of the debtor's assets to a creditor immediately before and in contemplation of bankruptcy was void and constituted an act of bankruptcy. "Such preference would be a fraud upon the whole bankrupt-laws, and defeat the two main ends of them: which are, 1st. The right the creditors have to the management, and disposal, of the bankrupt's estate, and effects. 2dly. An equal distribution amongst them."[76]

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and dealing . . . .

Id. This element may be compared to § 547(c)(2)(A), which requires the debt to have been incurred in the ordinary course of business.

71. *Id.* The statute required that the creditor receive the payment "before the suing forth of such commission . . . really and *bona fide*, and in the usual and ordinary course of trade and dealing." This requirement mirrors § 547(c)(2)(B) and (C), which require the payment to be made in the ordinary course of business and according to ordinary business terms.

72. *Id.* The creditor had to receive the payment "before such time as the person receiving the same shall know, understand, or have notice that he [the debtor] is become a bankrupt, or that he is in insolvent circumstances." *Id.* This final element reflects the requirement under § 60b of the 1898 Act that the creditor could be compelled to return a preference only if it had reasonable cause to believe that the debtor was insolvent at the time of the transfer.

73. 2 WILLIAM BLACKSTONE, COMMENTARIES *486. Blackstone compared this approach with that of France, where "every act of a merchant, for ten days *precedent* to the act of bankruptcy, is presumed to be fraudulent, and is therefore void." *Id.* Thus, my proposal in this Article agrees more with the position of the French in the middle of the eighteenth century.

74. *Hinton's Case*, *cited in* JOHN LOWELL & JAMES A. LOWELL, A TREATISE ON THE LAW OF BANKRUPTCY § 64, at 44 & n.2 (1899).

75. 96 Eng. Rep. 1160 (K.B. 1758); *see* discussion of *Worsley* in *In re* Hall, 4 Am. Bankr. Rep. 671, 680 (W.D.N.Y. 1900); LOWELL & LOWELL, *supra* note 74, § 64, at 44-45; McCoid, *supra* note 2, at 252.

76. *Worsley*, 96 Eng. Rep. at 1164.

Even though the facts of the case involved the debtor's retention of possession after the giving of the deed of his stock in trade, and thus fraud under the famous *Twyne's Case*, Lord Mansfield's reasoning did not depend on that circumstance: "Suppose, just before, and in contemplation of an intended bankruptcy, such a deed, of all his effects, was made, and possession instantly delivered, this would still be an undue preference, and must be unjust, if not corrupt."[77]

A decade later that which had been presaged in *Worsley* was realized in *Alderson v. Temple*,[78] which is "considered the leading case on this subject"[79] and in which Lord Mansfield struck down a prebankruptcy preferential transfer as void.[80] At the same time, he made clear that not all such transfers are vulnerable.[81] Two strands of a preference safe harbor appear. First, in the passage that the introduction to this article quotes,[82] he initiated the idea—still followed in England, but abandoned in the United States[83]—that a preference given in response to creditor pressure is valid.[84] Thus, a bad preference required an intent on the part of the debtor to prefer the creditor to the wrong of other creditors.[85] Second, following the lead of the 1746 Statute[86] that three years earlier Blackstone had affirmed as wise,[87] he recognized by negative inference an exception for prebankruptcy transfers made in the ordinary course of business. He stated that "a conveyance of all a man's property in trade to pay a bona fide creditor of the most meritorious nature . . . is fraudulent . . . *[b]ecause it is not an act in the ordinary course of business* . . . and it defeats the equality intended by the law."[88] Still later, he noted, "I am always diffident of hurting the course of trade and commerce."[89]

It has been remarked that "[t]he judges, not excepting Lord

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77. *Id.* at 1165.

78. 96 Eng. Rep. 384 (K.B. 1768); *see Hall*, 4 Am. Bankr. Rep. at 679-80; LOWELL & LOWELL, *supra* note 74, § 64, at 45-46; McCoid, *supra* note 2, at 251-53.

79. LOWELL & LOWELL, *supra* note 74, § 64, at 45.

80. The debtor mailed a £600 note to one of his creditors on a Friday morning, and then on Saturday morning "committed several acts of bankruptcy, upon which a commission issued." *Alderson*, 96 Eng. Rep. at 385.

81. *Id.*; *see Hall*, 4 Am. Bankr. Rep. at 679-80.

82. *See supra* note 2 and accompanying text.

83. *See* 3 COLLIER ON BANKRUPTCY, pt. 2, ¶ 60.02[1], at 760-61 (James W. Moore et al. eds., 14th ed. 1977); McCoid, *supra* note 2, at 252.

84. *Alderson*, 96 Eng. Rep. at 385.

85. *See Hall*, 4 Am. Bankr. Rep. at 680; McCoid, *supra* note 2, at 252-53.

86. *See supra* notes 67-72 and accompanying text.

87. *See supra* note 73 and accompanying text.

88. *Alderson*, 96 Eng. Rep. at 385 (emphasis added); *see* 1 EDWARD E. DEACON, THE LAW AND PRACTICE OF BANKRUPTCY 609 (Albert G. Langley ed., 3d ed. London 1864); Morris, *supra* note 1, at 739.

89. *Alderson*, 96 Eng. Rep. at 385.

Mansfield himself, appear to have been alarmed at their audacity in establishing this new fraud, and they proceeded to confine it within narrow and inadequate limits. They held that the course of trade must not be interfered with . . . ."[90]

B. *United States Preference Law in the Nineteenth Century Prior to the 1898 Act*

1. *Prior to the Bankruptcy Act of 1841*

At the time that the Bankruptcy Clause[91] was included in the United States Constitution, the English had developed a doctrine of preferences that entailed not only recapture of prebankruptcy transfers but also a safe harbor for ordinary course transfers. The first United States bankruptcy law, the Bankruptcy Act of 1800,[92] did not speak to the question of preferences made prior to the commission of the act of bankruptcy.[93] The statute did contain a relation back rule, which gave effect to assignments by the bankruptcy commissioners of the bankrupt's assets even as against persons who took from the bankrupt prior to the commencement of the bankruptcy case but after the commission of the act of bankruptcy.[94] However, the same section of the law contained a safe harbor derived in spirit from the 1746 English statute and exempted those who took from the bankrupt by bona fide purchase, for a valuable consideration, and with no knowledge, information, or notice of the act of bankruptcy.[95]

Some judicial decisions followed the English cases and permitted the recapture of preferences.[96] Justice Marshall in *Harrison v. Sterry*[97] voided an assignment that the debtor made shortly before bankruptcy. Without any discussion of the English or any other authorities, he stated:

> It is made under circumstances which expose it to the charge of being a fraud on the bankrupt laws.

90. LOWELL & LOWELL, *supra* note 74, § 65, at 46.

91. U.S. CONST. art. I, § 8, ch. 4.

92. An Act to Establish an Uniform System of Bankruptcy Throughout the United States, ch. 19, 2 Stat. 19 (1800) (repealed 1803) [hereinafter Bankruptcy Act of 1800].

93. *See* Countryman, *supra* note 9, at 719; McCoid, *supra* note 2, at 253; Ward & Shulman, *supra* note 52, at 5 n.2.

94. Bankruptcy Act of 1800, ch. 19, § 10, 2 Stat. 19, 24 (repealed 1803).

95. *Id.*

96. *See* McCoid, *supra* note 2, at 253 (citing Locke v. Winning, 3 Mass. 325 (1807)); Ward & Shulman, *supra* note 52, at 5 n.2 (citing Locke v. Winning, 3 Mass. 325 (1807)).

97. 9 U.S. (5 Cranch) 289 (1809).

> [I]t is dated but a few days before their bankruptcy; . . . and is made at a time when there is much reason to believe, from the face of the deed, as well as from extrinsic circumstances, that such an event was in contemplation.[98]

Here again the debtor's intent ("in contemplation"), which was derived from the circumstances, appears to be determinative. Justice Marshall did not specify exactly what it was that the debtor was in contemplation of, bankruptcy or insolvency, a distinction which the courts grappled with in the nineteenth century.[99] Justice Marshall went on to note that "[m]oney actually advanced upon the credit of this assignment, subsequent to its date, might perhaps be secured by it."[100] This was an early judicial recognition of the policy that is now embodied in the subsequent advance exception of section 547(c)(4). However, he found no evidence that any money actually had been advanced upon the assignment.[101]

Following the 1803 repeal of the Bankruptcy Act of 1800,[102] the regulation of bankruptcy and insolvency was relegated to the states for thirty-eight years. The most important state insolvency statute, in terms of its impact on future federal bankruptcy legislation, is generally thought to be the Massachusetts Insolvency Law of 1838.[103] The Massachusetts law initially focused on the *debtor's* intention as the critical element in defining a preference and required proof that the debtor acted in "contemplation of insolvency" and with a "view"[104] or "intending to give a preference."[105] As discussed below,[106] in 1841 the Massachusetts law added the requirement that "the creditor, when accepting such preference, [have] reasonable cause to believe such debtor was insolvent."[107]

Although the Massachusetts law was initially enacted before the federal Bankruptcy Act of 1841, many of the important cases under that Massachusetts law came after the repeal of the 1841 Act in 1843. The judicial decisions under the federal act and the Massachusetts law

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98. *Id.* at 301.

99. *See* LOWELL & LOWELL, *supra* note 74, § 69, at 49-50.

100. *Harrison*, 9 U.S. (5 Cranch) at 301.

101. *Id.*

102. Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

103. Insolvency Law of 1838, ch. 163, 1838 Mass. Acts; *see In re* Hall, 4 Am. Bankr. Rep. 671, 684 (W.D.N.Y. 1900); LOWELL & LOWELL, *supra* note 74, § 66, at 47; McCoid, *supra* note 2, at 254-56.

104. Insolvency Law of 1838, ch. 163, § 10, 1838 Mass. Acts.

105. Act of Mar. 18, 1841, ch. 124, § 3, 1841 Mass. Acts. For additional discussion on the impact of the Massachusetts law, see McCoid, *supra* note 2, at 255-56.

106. *See infra* notes 147-48 and accompanying text.

107. Act of Mar. 18, 1841, ch. 124, § 3, 1841 Mass. Acts, *quoted in* McCoid, *supra* note 2, at 257.

therefore informed each other. In one well-known 1848 case, *Denny v. Dana*,[108] the Massachusetts court held that intent to prefer could be inferred from the fact that the debtor knew he was insolvent:

> The intent to prefer is essential, but every person is to be presumed to intend the natural and probable consequences of his own acts; and if such acts do, in fact, as this does, give a very large preference, it is competent for the jury to infer the intent. It does not rebut this intent, to show that the debtor has also another motive to the proceeding, namely, an expectation of pecuniary or other future benefit to himself, by means of further loans of money, and being enabled thereby to continue his business.[109]

2. *The Bankruptcy Act of 1841*

The first federal bankruptcy statute that directly addressed the question of preferences was the Bankruptcy Act of 1841.[110] Section 2 defined preferences, provided for their recapture, barred the discharge of a person making such a preference, and established a safe harbor for certain transactions more than two months before bankruptcy.[111] Referee Hotchkiss observed in a lengthy opinion written in 1900 that detailed the history of the preference law: "It will at once be seen that

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108. 56 Mass. (2 Cush.) 160 (1848).

109. *Id.* at 172; *see* LOWELL & LOWELL, *supra* note 74, § 71, at 52-53; McCoid, *supra* note 2, at 255-56.

110. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 9, 5 Stat. 440 (1841) (repealed 1843) [hereinafter Bankruptcy Act of 1841].

111. *Id.* § 2, 5 Stat. at 422. Section 2 provided in part:

> *And be it further enacted*, That all future payments, securities, conveyances, or transfers of property, or agreements made or given by any bankrupt, in contemplation of bankruptcy, and for the purpose of giving any creditor, endorser, surety, or other person, any preference or priority over the general creditors of such bankrupts; and all other payments, securities, conveyances, or transfers of property, or agreements made or given by such bankrupt in contemplation of bankruptcy, to any person or persons whatever, not being a bona fide creditor or purchaser, for a valuable consideration, without notice, shall be deemed utterly void, and a fraud upon this act; and the assignee under the bankruptcy shall be entitled to claim, sue for, recover, and receive the same as part of the assets of the bankruptcy; and the person making such unlawful preferences and payments shall receive no discharge under the provisions of this act: *Provided*, That all dealings and transactions by and with any bankrupt, bona fide made and entered into more than two months before the petition filed against him, or by him, shall not be invalidated or affected by this act: *Provided*, That the other party to any such dealings or transactions had no notice of a prior act of bankruptcy, or of the intention of the bankrupt to take the benefit of this act.

Id.

this definition was an inartistic jumble of the then English definition of preference with those sections of the English law which took innocent transactions which accomplished 'preferences,' but not 'fraudulent preferences,' out from the ban of the law."[112]

As with the Massachusetts Insolvency Law, the critical element of a voidable preference under the 1841 Act was the intention of the *debtor*. Section 2 required proof that the debtor acted "in contemplation of bankruptcy, and for the purpose of giving [a] preference."[113] A nineteenth century commentator noted that "[t]he words 'in contemplation of bankruptcy,' as used in the bankrupt law, mean a contemplation of a state of bankruptcy merely, and not an intention to take the benefit of the bankrupt law."[114]

The case law interpreting the statute, with many of the important decisions by Justice Story, indicated that the debtor's intent to prefer and "contemplation" would be judged largely on the objective facts apparent to the debtor.[115] As one commentator said, "If a debtor is insolvent, and knows it, his intent to prefer may be presumed."[116] However, the decisions were far from uniform on this point.[117] The English rule that creditor pressure validated the preference[118] was not followed.[119]

No outside statutory time limit was placed on the preference reach back,[120] except for the two month safe harbor mentioned below. As long as the necessary intention of the debtor could be proved, recapture was possible. Of course, as a practical matter, the more distant the bankruptcy became, the more difficult the proof became.

The only relevance of the creditor's state of mind was with regard to the safe harbor for transactions more than two months before the bankruptcy filing.[121] Within the two months the focus was entirely on the debtor. In addition to the requirement that those transactions be "bona fide made and entered into" (reminiscent of section

112. *In re* Hall, 4 Am. Bankr. Rep. 671, 684 (W.D.N.Y. 1900).

113. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843).

114. EDWARD AVERY & GEORGE M. HOBBS, THE BANKRUPT LAW OF THE UNITED STATES 257 (1868).

115. For the cases and a discussion, see LOWELL & LOWELL, *supra* note 74, § 71, at 52; Glenn, *supra* note 46, at 535-37; McCoid, *supra* note 2, at 253-54.

116. LOWELL & LOWELL, *supra* note 74, § 73, at 56.

117. *See* AVERY & HOBBS, *supra* note 114, at 253-58 (discussing different interpretations of "contemplation of bankruptcy" and "contemplation of insolvency").

118. *See supra* notes 83-84 and accompanying text.

119. *See* Glenn, *supra* note 46, at 535-37.

120. Some modern commentators advocate returning to this system which eschews an arbitrary time limitation. *See* Kraus, *supra* note 18, at 1458; *see supra* note 47 and *infra* note 283 and accompanying text.

121. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843); *see* McCoid, *supra* note 2, at 257.

547(c)(2)(A)), the exclusion in section 2 contained a proviso that the creditor must have "had no notice of a prior act of bankruptcy, or of the intention of the bankrupt to take the benefit of this act."[122]

3. *The Bankruptcy Act of 1867*

Almost a quarter century after the 1841 Act was repealed in 1843,[123] Congress again exercised its power under the Bankruptcy Clause in enacting the Bankruptcy Act of 1867.[124] This Act contained in section 35[125] the most detailed statutory provision dealing with preferences to date and in section 39[126] for the first time[127] made the giving of a preference an act of bankruptcy that would support an involuntary bankruptcy proceeding. These two sections were construed in *pari materia.*[128] The preference provisions of the 1867 Act seem to be derived much more directly from the Massachusetts Insolvency Law than from the Bankruptcy Act of 1841.[129]

In the 1867 Act a number of threads of preference law are brought together. In a sense, that Act serves as the bridge between the earliest notions of preference law and those obtaining in more recent times. First, consistent with all prior preference rules, legislative or judicial, a wrongful intent on the part of the debtor was required. Section 35 required the debtor to have acted "with a view to give a preference."[130]

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122. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843).

123. An Act to Repeal the Bankrupt Act, ch. 82, 5 Stat. 614 (1843).

124. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 176, 14 Stat. 517 (1867) (repealed 1878) [hereinafter Bankruptcy Act of 1867].

125. *Id.* § 35, 14 Stat. at 534. Section 35 provided in part:

> *And be it further enacted,* That if any person, being insolvent, or in contemplation of insolvency, within four months before the filing of the petition by or against him, with a view to give a preference to any creditor or person having a claim against him, or who is under any liability for him, procures any part of his property to be attached, sequestered, or seized on execution, or makes any payment, pledge, assignment, transfer, or conveyance of any part of his property, either directly or indirectly, absolutely or conditionally, the person receiving such payment, pledge, assignment, transfer, or conveyance, or to be benefited thereby, or by such attachment, having reasonable cause to believe such person is insolvent, and that such attachment, payment, pledge, assignment, or conveyance is made in fraud of the provisions of this act, the same shall be void, and the assignee may recover the property, or the value of it, from the person so receiving it, or so to be benefited . . . .

Id.

126. *Id.* § 39, 14 Stat. at 536.

127. *See In re* Hall, 4 Am. Bankr. Rep. 671, 684 (W.D.N.Y. 1900).

128. ORLANDO F. BUMP, LAW AND PRACTICE IN BANKRUPTCY 398 (1871).

129. *See Hall*, 4 Am. Bankr. Rep. at 684; LOWELL & LOWELL, *supra* note 74, § 66, at 47; McCoid, *supra* note 2, at 254-58.

130. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

As under the 1841 Act, the great majority of the cases focused on objective circumstances known to the debtor in assessing whether the debtor acted "with a view to give a preference."[131] This objective approach was confirmed emphatically by the Supreme Court in 1871 in *Toof v. Martin*.[132]

> That the conveyances to Toof, Phillips & Co. were made with a view to give them a preference over other creditors hardly admits of a doubt. The bankrupts knew at the time their insolvent condition. . . . Making a transfer of property to these creditors, under these circumstances, was in fact giving them a preference, and it must be presumed that the bankrupts intended this result at the time. It is a general principle that every one must be presumed to intend the necessary consequences of his acts. The transfer, in any case, by a debtor, of a large portion of his property, while he is insolvent, to one creditor, without making provision for an equal distribution of its proceeds to all his creditors, necessarily operates as a preference to him, and must be taken as conclusive evidence that a preference was intended, unless the debtor can show that he was at the time ignorant of his insolvency, and that his affairs were such that he could reasonably expect to pay all his debts. The burden of proof is upon him in such a case . . . .[133]

Under this construction of the statute, the requirement of debtor intent had little vitality independent of the insolvency test. A leading commentator observed that "the decisions under the Act placed a minimum emphasis upon such intent [of the debtor]."[134] This state of affairs finally was given statutory recognition in the 1898 Act, which dispensed entirely with proof of any element of debtor intent.[135]

Section 35 also required that the debtor either actually *be* insolvent, *or* act "in contemplation of insolvency."[136] This formulation dispensed with the mens rea relating to insolvency entirely if the debtor in fact was in that state,[137] thus beginning a transition completed in the 1898 Act.[138] It also shifted what the debtor had to be in contemplation of from "bankruptcy" under the 1841 law to "insolvency" under the 1867 Act. The decisions viewed these as materially distinct

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131. *See* cases digested in BUMP, *supra* note 128, at 402-04.

132. 80 U.S. (13 Wall.) 40 (1871).

133. *Id.* at 48.

134. 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.05[1], at 771.

135. *See infra* notes 158-66 and accompanying text.

136. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

137. *See* BUMP, *supra* note 128, at 400.

138. *See* Bankruptcy Act of 1898, ch. 541, § 60a, 30 Stat. 544, 562 (repealed 1978); *see infra* note 158 and accompanying text.

inquiries.[139]

The 1867 Act effected a shift from the early English decisions and from the 1841 Act by imposing an absolute four month limit before bankruptcy on the period of vulnerability.[140] In 1874 this period was reduced to two months for involuntary cases.[141] In England, as mentioned earlier, all transfers made after commission of the act of bankruptcy were potentially at risk.[142] The English 1746 safe harbor statute had been cast in terms of the bona fides of the transaction and lacked any specific time bar.[143] Lord Mansfield had spoken only of "the eve of bankruptcy."[144] The Bankruptcy Act of 1841 contained a two month provision. However, the exclusion was not absolute and depended both on the bona fides of the transaction and the recipient's lack of notice of anything suspect.[145] This innovation of the 1867 law, as with many other aspects of it, apparently was copied from the Massachusetts statute.[146] An absolute time limit has been a part of all United States preference laws since 1867.

The Bankruptcy Act of 1867 added another component to the preference equation, again borrowed from Massachusetts[147]: the requirement that the creditor recipient of the preference have reasonable cause to believe that the debtor was insolvent at the time of the transfer, *and* that the payment was "made in fraud of the provisions of this act."[148] Creditor knowledge had never before been considered a factor in defining a preference, except to the limited extent relevant for the two-month safe harbor under the 1841 law.[149] Indeed, the English view, adhered to unfailingly ever since *Alderson v. Temple*[150] in 1768, was that a preference given in response to creditor pressure was not voluntary on the part of the debtor and thus not fraudulent.[151]

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139. *See* BUMP, *supra* note 128, at 398.

140. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

141. Act of June 22, 1874, ch. 390, sec. 10, § 35, 18 Stat. 178, 180 (repealed 1878).

142. 2 WILLIAM BLACKSTONE, COMMENTARIES *485-86.

143. 19 Geo. 2, ch. 32, § 1 (1746) (Eng.).

144. Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768).

145. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843); *see supra* note 111 and accompanying text.

146. *See* McCoid, *supra* note 2, at 259. The time limit in Massachusetts was six months. *See* Act of Mar. 18, 1841, ch. 124, § 3, 1841 Mass. Acts.

147. *See* McCoid, *supra* note 2, at 257-58; *see supra* notes 106-07 and accompanying text.

148. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

149. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843); *see supra* note 111 and accompanying text.

150. 96 Eng. Rep. 384, 385 (K.B. 1768); *see supra* notes 82-84 and accompanying text.

151. *See* DEACON, *supra* note 88, at 607.

The introduction in 1867 of the requirement that the creditor have reasonable cause to believe that the debtor was insolvent perhaps more than any other event led to the direct consideration by judges of the issue of whether the payment had occurred in the ordinary course of business as relevant to the preference determination. Section 35 of the 1867 law had an express provision stating that "if such sale, assignment, transfer, or conveyance is not made in the usual and ordinary course of business of the debtor, the fact shall be prima facie evidence of fraud."[152] The manner of phrasing this statutory presumption suggests the negative inference that transfers that *were* made in the "usual and ordinary course of business" should be presumed prima facie to be valid; the cases under the 1867 law in fact made that inference.[153]

Judge Lowell, writing before the passage of the 1898 Act,[154] discussed the impact of proof that the transfer was in the "usual course of business" as relevant to a showing that the debtor did or did not have the requisite intent to prefer.[155] He also suggested that such evidence bears on proof of creditor's knowledge. He observed:

> In England, as we have seen, payment and security given in the ordinary course of trade are protected. In this country, intent is a question of fact; and while a payment in the ordinary course of trade will rarely be a preference, yet it may happen to be so in some cases. On the other hand, an act done out of the usual course of the debtor's business is, by most of the statutes, and would be by decision, notice to the preferred creditor that something may be wrong.[156]

C. *The Bankruptcy Act of 1898 and Amendments*

The preference avoidance and recovery provisions in section 60 of the Bankruptcy Act of 1898[157] completed and carried forward many of the transitional ideas and innovations introduced in the 1867 Act. First, the requirement that the debtor have an intent to prefer the creditor, present but often almost meaningless in the 1867 Act,[158] was finally and formally abandoned in section 60,[159] although not without

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152. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

153. For a collection of these cases, see BUMP, *supra* note 128, at 406-07 (especially *Driggs v. Moore, Foote & Co.*, *Collins v. Bell*, and *Scammon v. Cole*).

154. *See* LOWELL & LOWELL, *supra* note 74, preface.

155. *Id.* § 74, at 56-57. The title to § 74 is "Intent, continued; Usual Course of Business." *Id.* at 56.

156. *Id.* § 74, at 56-57.

157. Bankruptcy Act of 1898, ch. 541, § 60, 30 Stat. 544, 562 (1898) (repealed 1978).

158. *See supra* notes 134-35 and accompanying text.

159. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.05[2.1], at 771-72;

confusion.[160] Although section 3a(2) continued to require the debtor's intent to prefer for a preference to constitute an act of bankruptcy,[161] no such intent was included in section 60, and the Supreme Court refused to infer such a requirement.[162] After amendments to sections 57g and 60 in 1903,[163] some courts mistakenly imposed a debtor intent requirement for avoidance and recovery of preferences.[164] Further amendments in 1910[165] corrected this judicial error, and debtor intent in connection with preference recapture has not been required since.[166]

The 1898 Act further limited recovery to situations in which the debtor in fact was "insolvent" at the time of the transfer.[167] The alternative proof available under the 1867 Act, that the debtor acted "in contemplation of insolvency,"[168] was discarded. Thus the "contemplation" provision finally passed out of the bankruptcy law.

At the same time, two prerequisites to recovery of a preference that were first introduced in 1867 were continued in section 60b of the 1898 Act: the requirement of a bad state of mind on the part of the recipient creditor, and a four month limit on the preference reachback.[169] The creditor knowledge requirement was altered slightly

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McCoid, *supra* note 2, at 256-57.

This step appears to have been taken at the instigation of the Senate because the bill proposed by the House retained the element of debtor intent. H.R. REP. No. 65, 55th Cong., 2d Sess. 21 (1897). The Conference Report, S. Doc. No. 294, 55th Cong., 2d Sess. 21 (1898), struck that language, without explanation.

160. For example, James Lowell, updating his father's treatise after the passage of the 1898 Act, concluded, "By considering paragraphs *a* and *b* [of § 60] together it will appear that in order that the transfer or judgment may be set aside by the trustee, it must have been given with an intent to prefer." LOWELL & LOWELL, *supra* note 74, § 523, at 480.

161. Bankruptcy Act of 1898, ch. 541, § 3a(2), 30 Stat. 544, 546. This requirement of intent to prefer as part of the definition of a preference as an act of bankruptcy was finally repealed in 1952. Act of July 7, 1952, ch. 579, sec. 3(a), § 3a, 66 Stat. 420, 421.

162. Pirie v. Chicago Title & Trust Co., 182 U.S. 438, 454-55 (1901).

163. Act of Feb. 5, 1903, ch. 487, secs. 12-13, §§ 57g, 60, 32 Stat. 797, 799-800.

164. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.05[2.2], at 773-74.

165. Act of June 25, 1910, ch. 412, sec. 11, § 60b, 36 Stat. 838, 842. As Professor Countryman observed, this amendment "eliminated the anomaly of section 60b's requirement that the creditor have reasonable cause to believe the debtor had an intent that section 60a did not require the debtor to have." Countryman, *supra* note 9, at 722.

166. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.05[2.3], at 775; 4 HAROLD REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES § 1703, at 323 (James M. Henderson ed., 1957); Countryman, *supra* note 9, at 723; *see also* HENRY C. BLACK, HANDBOOK OF THE LAW AND PRACTICE IN BANKRUPTCY § 259, at 621 (2d ed. 1930).

167. Bankruptcy Act of 1898, ch. 541, § 60a, 30 Stat. 544, 562 (repealed 1978).

168. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878); *see supra* notes 136-39 and accompanying text.

169. Bankruptcy Act of 1898, ch. 541, § 60b, 30 Stat. 544, 562 (repealed 1978).

from the 1867 test demanding knowledge that the debtor was "insolvent"[170] to the 1898 section 60b test that the creditor "shall have had reasonable cause to believe that it was intended thereby to give a preference."[171] In 1910 this was amended to "reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference"[172] in order to eliminate the misconstruction that debtor intent must be proven.[173]

The change from the 1867 version to 1898 is not explained in the House Report[174] or the Conference Report.[175] Perhaps the difference was not too great. Judge Lowell, writing before the 1898 Act was passed, noted that "cause to believe insolvency proves cause to believe the intent to prefer."[176] Henry Black, writing after 1898 but before the 1938 amendments, also concluded that "[i]f the creditor knows or has reasonable ground to believe that the debtor is insolvent, then it may be inferred without further proof that he also has reasonable ground to believe that the enforcement of the judgment or transfer which he takes will effect a preference."[177] In the major 1938 revision, Congress went back to the 1867 test, which required "reasonable cause to believe that the debtor is insolvent."[178] The test remained in that form until it was repealed along with the rest of the Bankruptcy Act in 1978.

The 1898 Act did not contain a provision like that of the 1867 Act which expressly provided that proof that a transfer was "not made in the usual and ordinary course of business" created a presumption of fraud.[179] In part, this may be attributable to the elimination of any

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As originally enacted, the preference surrender provision of § 57g referred only to "creditors who have received preferences." *Id.* § 57g, 30 Stat. at 560. Section 60a, which defined "preferences," said nothing about the four-month and reasonable cause to believe tests, which applied only to avoidance and recovery of the preference under § 60b. The Supreme Court held in Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901), that the statute meant what it said, namely that a preference taken by a creditor who lacked reasonable cause to believe a preference was intended had to be surrendered under § 57g before the creditor could prove its claim. *Id.* at 447-55. Section 57g was amended in 1903 to change this result, so that only the surrender of preferences voidable under § 60b was required as a prerequisite to proving a claim. Act of Feb. 5, 1903, ch. 487, sec. 12, § 57g, 32 Stat. 797, 799.

170. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878).

171. Bankruptcy Act of 1898, ch. 541, § 60b, 30 Stat. 544, 562 (repealed 1978).

172. Act of June 25, 1910, ch. 412, sec. 11, § 60b, 36 Stat. 838, 842.

173. *See supra* notes 163-66 and accompanying text.

174. H.R. REP. No. 65, 55th Cong., 2d Sess. 21 (1897).

175. S. Doc. No. 294, 55th Cong., 2d Sess. 21 (1898).

176. LOWELL & LOWELL, *supra* note 74, § 99, at 79. Judge Lowell went on to note that "the unusual character of the transaction is such evidence." *Id.*

177. BLACK, *supra* note 166, § 260, at 622.

178. Chandler Act, ch. 575, § 60b, 52 Stat. 840, 870 (1938) (repealed 1978).

179. Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878); *see*

element of debtor intent, and a corresponding deemphasis on the fraudulent nature of a preference. Nevertheless, as under the 1867 law, ordinary course transactions still tended to escape recapture, on several theories.

One way that ordinary course payments were protected was through the operation of the reasonable cause to believe test of section 60b.[180] Collier stated:

> Payments received by a creditor in the ordinary course of business with an insolvent debtor are not necessarily voidable. The acceptance of payments with no special purpose of obtaining advantage over other creditors but in accordance with the creditor's general method of collecting outstanding accounts will not give rise to reasonable cause to believe that the debtor is insolvent.[181]

Another justification for excluding certain ordinary course transfers from the reach of the preference section was on the ground that the payment was for a "current expense"[182] and that in essence no depletion or diminution of the debtor's estate was accomplished thereby. This diminution notion was considered "implicit in the very nature of a preference"[183] and also implied from the antecedent debt requirement.[184] The payment of these "current expenses" was protected from preference recapture on the same theoretical grounds as cash transactions.[185] The extension of the credit and the payment were seen as in substance "one transaction,"[186] even though technically for an antece-

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supra notes 152-53 and accompanying text.

180. *See* Broome, *supra* note 9, at 89; DeSimone, *supra* note 10, at 104; Herbert, *supra* note 40, at 679; Morris, *supra* note 1, at 762.

181. 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.54[4], at 1082.1.

182. *See* DeSimone, *supra* note 10, at 104; Ward & Shulman, *supra* note 52, at 19-20.

183. 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.20, at 856-57.

184. *Id.* at 858-59; Broome, *supra* note 9, at 90 & n.68.

185. Collier stated:

> [W]here the debtor engages in a cash transaction whereby he purchases goods and pays a reasonable sum for them, such payment does not constitute a preference under § 60. Obviously in such a situation there is no depletion of the debtor's estate for an antecedent debt. *Similarly payments on account of current expenses incidental to the operation of a business are generally not within the category of preferential transfers.*

3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.23, at 872-73 (emphasis added). Professors Ward and Shulman referred to these as "like-cash" transactions. Ward & Shulman, *supra* note 52, at 18 n.45.

186. 3 COLLIER ON BANKRUPTCY, *supra* note 83, pt. 2, ¶ 60.19, at 851-53. According to Collier:

> [S]uch a transfer of property by the debtor does not necessarily effect a preference . . . where it appears that there was but one transaction . . . . In the same category also are advancements upon security for current business opera-

dent debt.[187] Many commentators believe that this judicially developed current expense concept led at least in part to section 547(c)(2).[188] Most of the decisions under the Act which held that payments in the ordinary course were not preferential are entitled to substantially less historical and precedential weight in defining and framing our own preference policy than might appear at first blush. This is due to the fact that many of those cases were not recapture cases under section 60 or even surrender cases under section 57g, but rather were asking only whether the debtor had made a preference that would qualify as an act of bankruptcy sufficient to support an involuntary petition under section 3a.[189] Under section 3a the debtor's intent to prefer was required until 1952.[190] That a transfer was made in the ordinary course of business might well be relevant to prove that the debtor lacked an intent to prefer. Our current law has, however, rejected any notion that the debtor's intent should be relevant to whether a preference should be recovered.

Only "a smattering of cases"[191] actually held that ordinary course is relevant to disprove a preference under section 60a (as opposed to an act of bankruptcy under section 3a or the section 60b reasonable cause test). As Professor Countryman observed, they did so "with no help from, or regard for, the language of the statute."[192] The main case generally cited is *Marshall v. Florida National Bank*,[193] in which $1356.11 in warehouse storage charges was paid during the preference period. The court declined to find a preference, reasoning that the payment had been in the "usual course of business" and had actually benefited

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> tions, or expenses. Likewise, payments of currently earned wages are not preferential in this respect, inasmuch as the labor performed constitutes a present consideration; and current payments of rent may be said to rest on a present consideration.

Id.

187. *See* Morris, *supra* note 1, at 762-63. Professor Morris observed that "courts have often had the good sense to avoid analyzing transactions on such a minute time scale. Multiple acts are looked upon as a single transaction." *Id.* at 763.

188. *See infra* note 238 and accompanying text. *See* Broome, *supra* note 9, at 89-91; Countryman, *supra* note 9, at 767-69; Herbert, *supra* note 40, at 679; Michael Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 201-02 (1980).

189. *See, e.g., In re* E.T. Russell Co., 291 F. 809, 812-15 (D. Mass. 1923); *In re* Perlhefter, 177 F. 299, 304 (S.D.N.Y. 1910); *In re* Douglas Coal & Coke Co., 131 F. 769, 775-76 (E.D. Tenn. 1904).

190. *See supra* note 161 and accompanying text.

191. *See* Countryman, *supra* note 9, at 768 & n.296; *see also* Broome, *supra* note 9, at 90 & n.68.

192. Countryman, *supra* note 9, at 768.

193. 112 F.2d 380 (5th Cir. 1940); *see* Union Bank v. Wolas, 112 S. Ct. 527, 531 (1991).

the debtor's estate.[194] To extrapolate the handful of cases decided over eighty years into a well-recognized judicial exception to preference recapture, as Collier did,[195] may well have been unwarranted.

D. The Bankruptcy Commission Report

In 1970 Congress established the Commission on the Bankruptcy Laws of the United States to "study, analyze, evaluate, and recommend changes to" the Bankruptcy Act.[196] The Commission filed its report in 1973, together with a draft "Bankruptcy Act of 1973."[197] The Commission recommended a "substantial revision" of the preference section.[198]

Most notably, the Commission proposed that the reasonable cause to believe test be abolished.[199] Congress made this significant change in the 1978 Code.[200] Abolition of the reasonable cause test, however, which had provided safety to many creditors under the Act, was thought to require some countervailing measures to ameliorate the impact of that action.[201] One was to shorten the time period of vulnerability to ninety days, from four months.[202]

The other was with regard to ordinary course transfers, previously protected in most instances by the reasonable cause test.[203] The Commission recommended a narrowly tailored exclusion from preference recapture, to be accomplished through the definition of "antecedent debt" in section 4-607(g)(1) of the proposed Act.[204] Professor Country-

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194. *Marshall*, 112 F.2d at 381-82. The court stated:

> [P]ayment of the storage charges was vital if the preserving company was to continue its business. . . . The payment to the warehouse company in no wise diminished the assets of the company, but on the other hand conserved the valuable merchandise which might have been advertised and sold for meager storage fees.

Id.

195. *See supra* note 185.

196. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

197. REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93rd Cong., 1st Sess., pt. I (report), pt. II (Bankruptcy Act of 1973) (1973) [hereinafter COMMISSION REPORT].

198. *Id.* pt. I, at 201.

199. *Id.* at 201-02, 204. The Commission Report stated that the reasonable cause "requirement, more than any other, has rendered ineffective the preference section of the present Act." *Id.* at 204.

200. *See* HOUSE REPORT, *supra* note 5, at 178.

201. *See* Nutovic, *supra* note 32, at 178.

202. *See* COMMISSION REPORT, *supra* note 197, pt. II, at 170 n.10 ("The reduction moderates the effect of eliminating the 'reasonable cause to believe' requirement.").

203. *See id.* at 169-70 n.6; *see supra* notes 170-78 and accompanying text.

204. COMMISSION REPORT, *supra* note 197, pt. II, § 4-607(g)(1), at 168. It stated:

man asserted that the Commission proposal was "an apparent attempt both to confine the earlier rulings under section 60 and to provide them with some statutory base."[205] All transfers within five days of the incurring of the debt were excluded,[206] following on the one transaction theory. Furthermore, all debts for personal services were excluded, as were debts for utilities incurred within the preference period and debts for inventory paid within three months of delivery in the ordinary course of business.[207]

In a rather conclusory manner[208] the Commission justified the latter exclusions on the ground that payment of those debts "does not infringe substantially on the goals of the preference provisions."[209] The Commission apparently was drawing heavily on an article by Professor Robert Morris.[210] That article discussed the problem that a strict interpretation of "antecedent debt" could, without the reasonable cause test, render preferential many routine transactions that in actuality are not thought of as extensions of credit.[211] Professor Morris accordingly recommended a grace period for all preferences.[212] The Commission noted that the reasonable cause to believe test previously protected most of those transfers,[213] but it was also recommending the abolition of that test for transfers within the three month preference period.[214]

The National Bankruptcy Conference criticized the Commission proposal as both too rigid and as providing too long a grace period.[215] It would have limited the protection to debts incurred within thirty days of payment.[216] The theory of protection was basically the same; only the particulars were disputed.

> "Antecedent debt" is a debt incurred more than five days before a transfer paying or securing the debt. "Antecedent debt" does not include (A) a debt for personal services; (B) a debt for utilities incurred within three months of the petition; (C) a debt for inventory paid for within three months of the delivery of the goods in the ordinary course of the debtor's business . . . .

Id.

205. Countryman, *supra* note 9, at 768.

206. *See supra* note 204.

207. *See id.*

208. *See* Nutovic, *supra* note 32, at 179.

209. COMMISSION REPORT, *supra* note 197, pt. I, at 205.

210. *See id.* pt. II, at 169-70 n.6 (citing Morris, *supra* note 1).

211. *See* Morris, *supra* note 1, at 761-68.

212. *Id.*

213. COMMISSION REPORT, *supra* note 197, pt. II, at 170 n.6.

214. *Id.* pt. I, at 201, 204.

215. *See* Broome, *supra* note 9, at 97 n.97; Countryman, *supra* note 9, at 768.

216. *See* Broome, *supra* note 9, at 98 n.97.

E. The Bankruptcy Reform Act of 1978

The recommendation of the Bankruptcy Commission was not followed precisely in the Bankruptcy Reform Act of 1978. The proposal to repeal the reasonable cause to believe test for transfers within the three month period was adopted. That test was seen as antithetical to the overriding preference purpose of promoting equality.[217]

However, the shape of the protection for short-term ordinary course transfers was different. Congress in 1978 settled on the ordinary course exception of section 547(c)(2), which eschewed specification of categories of debt (*e.g.*, personal services, utilities, and inventory)[218] and instead imposed the limitations of "ordinary course" and that payment be within forty-five days after the debt was incurred.[219] Professor Broome's examination of the mark-up minutes of the House subcommittee staff indicated that the principal concern, as under the current expense rule and the Commission Bill, still was with protecting the payment of ordinary trade debts that were " 'not truly antecedent.' "[220]

The House Report itself was more vague, stating that the purpose of the exception was "to leave undisturbed normal financial relations."[221] Accompanied by the forty-five day limitation, however, together with the repeal of the reasonable cause test, the intended effect of the 1978 Code nevertheless was to narrow the scope of excepted payments from that under the Act and to make the goal of equality

217. *See* HOUSE REPORT, *supra* note 5, at 177-78; *see supra* notes 49-50, 52-53 and accompanying text.

218. Those excluded from the list of preference exceptions in the Commission Bill not surprisingly complained that they were being unfairly discriminated against. *See* Nutovic, *supra* note 32, at 179.

219. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 547(c)(2), 92 Stat. 2549, 2598 (codified at 11 U.S.C. § 547(c)(2) (1988)). Specifically, § 547(c)(2) provided:

> (c) The trustee may not avoid under this section a transfer—
>
> . . .
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made not later than 45 days after such debt was incurred;
>
> (C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (D) made according to ordinary business terms.

Id.

220. Broome, *supra* note 9, at 98 n.97 (quoting *Minutes of the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 552 (1977) (statement of Mr. Klee)); *see also* Ward & Shulman, *supra* note 52, at 23 & nn. 65-66.

221. HOUSE REPORT, *supra* note 5, at 373; *see supra* note 51 and accompanying text.

paramount.[222]

F. *The 1984 Amendments and* Wolas

Trouble developed fairly quickly with the ordinary course exception under the Bankruptcy Code, on two fronts. First, the courts ran into considerable difficulty in applying the forty-five day limitation.[223] The expressed goal of "a reduction in litigation and more efficient administration"[224] was not being fully realized. Second, the limitation was assailed as unfairly discriminatory against creditors with a trade cycle longer than forty-five days[225] and as undermining the market for short-term commercial paper.[226]

After considering a wide variety of alternatives,[227] Congress ultimately responded to these various complaints in 1984 by repealing the forty-five day limitation in section 547(c)(2)(B).[228] An interesting colloquy between Senators Dole and DeConcini was inserted into the Congressional Record to bolster the view that payment of short-term commercial paper at maturity now would be protected under section 547(c)(2).[229] Repealing the forty-five day limitation, however, went far

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222. *See* HOUSE REPORT, *supra* note 5, at 177-78; Levin, *supra* note 53, at 183-84; *see supra* note 217 and accompanying text.

223. *See* Broome, *supra* note 9, at 102 & n.114; Countryman, *supra* note 9, at 770; DeSimone, *supra* note 10, at 96, 108. This problem had been predicted early on by two commentators, who noted that "the basic requirement that the payment of the debt be made within forty-five days after the debt was incurred suffers from vagueness." Chaim J. Fortgang & Lawrence P. King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1167 (1981). Experience proved them correct.

224. HOUSE REPORT, *supra* note 5, at 179.

225. *See* S. REP. No. 65, 98th Cong., 1st Sess. 60 (1983); Fortgang & King, *supra* note 223, at 1168-69; *see also* Broome, *supra* note 9, at 100-02; DeSimone, *supra* note 10, at 111.

226. Fortgang & King, *supra* note 223, at 1169-70; *see also* Broome, *supra* note 9, at 102-04; Countryman, *supra* note 9, at 770-72.

227. The legislative history leading up to the 1984 repeal of § 547(c)(2)(B) is detailed in Broome, *supra* note 9, at 99-112. *See also* Countryman, *supra* note 9, at 770-72.

228. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 462(c), § 547(c)(2), 98 Stat. 333, 378.

229. 130 CONG. REC. 20,091 (1984).

> Mr. DeConcini: . . . . Am I correct that the elimination of the 45-day restriction in subsection (c)(2) of section 547 will relieve buyers of commercial paper with maturities in excess of 45 days of the concern that repayments of such paper at maturity might be considered as preferential transfers?
> Mr. Dole: That is correct, assuming that the "ordinary course of business or financial affairs" and "ordinary business terms" requirements are met.
> Mr. DeConcini: Would there be any doubt that companies that have a need for short-term funds, and investors who wish to purchase short-term obligations, would both be acting in their respective "ordinary course of business or finan-

beyond merely protecting short-term commercial paper.[230] In one ill-considered stroke of the legislative pen, Congress effectively undercut the major premise of the preference reform effected in 1978—that of making equality of distribution the paramount policy. The completeness of the evisceration of the equality principle is evidenced by the *Union Bank v. Wolas*[231] decision in December 1991, which held that payments on a seven million dollar long-term loan could fall within the protective ambit of section 547(c)(2) as amended in 1984.[232]

Another round of bankruptcy reform is in the offing, with S. 1985 being passed unanimously by the Senate on June 17, 1992.[233] Title I of that bill, which Senators Heflin and Grassley sponsored as a bipartisan measure, proposes the creation of another National Bankruptcy Review Commission similar to that established in 1970. The bill does not itself propose any changes to section 547(c)(2). However, it seems likely that the Commission, if established, will look into the operation of this controversial provision. In the next Part, I examine in detail three normative justifications for the ordinary course exception.

IV. NORMATIVE JUSTIFICATIONS FOR THE ORDINARY COURSE EXCEPTION AND CRITIQUES THEREOF

A. *Introduction*

The nagging question remains whether this assumed need for protecting ordinary course transfers stands up to close scrutiny. What is so sacrosanct about payments in the ordinary course of business by an insolvent debtor on the brink of bankruptcy? Surprisingly, it is somewhat difficult to find a direct normative answer that is more than a conclusory statement that "normal financial relations" should be left undisturbed (as in the 1977 House Report).[234]

Three explanations nonetheless may be offered. The first, insulating payment of current expenses, is drawn from the possible genesis of

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> cial affairs" if they were to deal directly or indirectly with each other in the commercial paper market? And would not the payment of a commercial paper note at maturity be in accordance with "ordinary business terms"?
>
> Mr. Dole: Those understandings are correct. The commercial paper market is an established market, and participants in it would presumably be acting in the ordinary course of their business or financial affairs and on the basis of ordinary business terms.

Id.

230. *See* Countryman, *supra* note 9, at 772; DeSimone, *supra* note 10, at 112.
231. 112 S. Ct. 527 (1991).
232. *Id.* at 533; *see supra* notes 9-14 and accompanying text.
233. 138 CONG. REC. D 736 (1992).
234. HOUSE REPORT, *supra* note 5, at 373; *see* Nutovic, *supra* note 32, at 180.

section 547(c)(2) in the judicial doctrine under the Act that protected those payments.[235] I have categorized the second as value maximization or the incentive effect. The final rationale that supports the ordinary course exception is furthering repose.

Aspects of the deterrence rationale pervade all three of these arguments. Indeed, the Supreme Court in *Union Bank v. Wolas*[236] stated that "the ordinary course of business exception may benefit all creditors by deterring the 'race to the courthouse' and enabling the struggling debtor to continue operating its business."[237] Nevertheless, I have not focused on the deterrence argument as a primary justification for the ordinary course exception in this part of the Article for several reasons. First, the merits of deterrence as a rationale are discussed in Part II above. Second, that discussion noted serious criticisms of the persuasiveness of the deterrence justification. Finally, I believe that deterrence as a primary focus is somewhat inapposite to the question of who gets to *keep* a preference, except in a negative inference sense.

B. Current Expenses

A number of commentators[238] and courts[239] have asserted that section 547(c)(2) is derived from the judicially developed current expense rule, although the Supreme Court in *Wolas* was skeptical.[240] As pointed out earlier,[241] the current expense doctrine was predicated largely on the idea that payment of a current account does not diminish the debtor's estate and is not really for an antecedent debt when one looks at the entire transaction—the credit extension and the payment—as a unit.[242] It would then be unfair to the creditor and a windfall to the other creditors to allow recovery of the payment while keeping the value obtained in exchange.[243] In addition, the prospect of preference recovery would cause trade creditors to demand cash up front, which would drive the debtor out of business.[244]

The latter prong of the argument basically describes the negative side of the incentive effect rationale, which is discussed in the next section of the Article. That leaves the no-diminution, no-antecedent

235. *See supra* notes 182-88 and accompanying text.
236. 112 S. Ct. 527 (1991).
237. *Id.* at 533.
238. *See supra* note 188 and accompanying text.
239. *See, e.g.,* Barash v. Public Fin. Corp., 658 F.2d 504, 511 (7th Cir. 1981).
240. *See Wolas*, 112 S. Ct. at 531.
241. *See supra* notes 182-87 and accompanying text.
242. *See Wolas*, 112 S. Ct. at 531; Broome, *supra* note 9, at 113.
243. *See* Ward & Shulman, *supra* note 52, at 18 n.45.
244. *See Wolas*, 112 S. Ct. at 531-32; Kaye, *supra* note 188, at 202.

debt argument as a justification for the current expense rule.

Before assessing the merits of that argument, a more basic point should be made. The current expense argument cannot justify the ordinary course exception, as presently constituted and as interpreted by the Supreme Court in *Wolas*, because section 547(c)(2) is not even remotely limited to protecting payments of current expenses. Now payments on *any* debt, even those incurred years in the past, potentially may be protected if that payment is held to be in the ordinary course of the debtor's business. Although some overinclusiveness in legislative drafting is often unavoidable,[245] section 547(c)(2) simply goes too far beyond merely protecting payments of current expenses to be justified on that ground alone. If that is in fact the only justification for the exception, then Congress needs to amend section 547(c)(2) to better accomplish the intended purpose.

There is no point in amending section 547(c)(2) to tailor it to the purpose of protecting current expenses if that goal itself is not compelling. Leaving the incentive argument to the next section, I suggest here that protecting the payment of current expenses cannot logically be justified on the no-diminution, no-antecedent debt ground.[246] To begin with the obvious, the debtor's estate *is* diminished by the payment, and the debt being paid *was* antecedent to the payment. Arguments to the contrary prove too much.

Assume a creditor *C* who ships $1000 of the proverbial widgets to the debtor *D* on credit, with payment expected within thirty days. After receipt of those widgets, and before payment, the debtor's estate includes the widgets, which are worth $1000. If the debtor were to file bankruptcy at that moment, the estate would include those widgets.[247] In a Chapter 7 case *all* unsecured creditors would have a pro rata claim against the value of those widgets—unless *C* has a valid reclamation claim, which is discussed below.[248]

The creditor, however, has only an unsecured general claim against the debtor for the $1000 debt, which was incurred (at the latest) when the debtor received the widgets. Even though payment may not be due immediately, the creditor does now have a right to payment. If the debtor were to file bankruptcy, the creditor would have a claim.[249] The debt therefore is defined to be antecedent to the payment, which in our hypothetical has not yet occurred. If the debtor is insolvent, which is

245. *See* BAIRD, *supra* note 5, at 156; JACKSON, *supra* note 1, at 130; Nutovic, *supra* note 32, at 185.

246. Professor Broome likewise rejected this argument. *See* Broome, *supra* note 9, at 113-15.

247. 11 U.S.C. § 541(a)(1) (1988 & Supp. II 1990).

248. *See infra* notes 251-54 and accompanying text.

249. 11 U.S.C. § 101(5)(A) (Supp. II 1990).

the only scenario in which a preference is vulnerable by definition,[250] the creditor would, however, receive less than full payment on the $1000 debt.

If the creditor were paid in full prior to bankruptcy, the creditor therefore is better off than under our hypothetical bankruptcy, in which it would receive less than full payment. Assuming that the payment came out of the debtor's estate, the estate is diminished to the extent of that $1000. The dividend to all the other creditors in the bankruptcy case will be reduced. This occurs because payments during the preference period are made in 100¢ dollars to a creditor whose claim against the insolvent debtor is measured in less than 100¢ dollars.

But it arguably would be unfair for a creditor who does not know that the debtor is insolvent to immediately lose money in one transaction by trading 100¢ dollars in goods or other value to the debtor in exchange for a claim worth less than 100¢ on the dollar. However, a creditor who extends credit knowing of the debtor's insolvency does not deserve the solicitude of the law, for that creditor knowingly took a chance. It is not a valid normative answer to say that section 547(c)(2) offers the promise of keeping a payment received, for that does not itself explain *why* section 547(c)(2) should contain such a rule. The only possible argument to assist such a creditor is the incentive justification, which is analyzed in the next section. It is worth noting here that other provisions of commercial law do *not* assist the creditor with knowledge.[251]

The creditor who extends credit in ignorance of the debtor's insolvency may in fact be protected by a reclamation claim under section 2-702 of the Uniform Commercial Code.[252] If the creditor does have such a reclamation claim, then payment might not be considered preferential because there might not be a preferential effect under section 547(b)(5) of the Bankruptcy Code.[253] To preserve that claim, the credi-

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250. *Id.* § 547(b)(3) (1988).

251. *See, e.g.*, U.C.C. § 2-702(2) & official cmt. 2 (1966), which provide only a reclamation right to a seller who discovers the buyer's insolvency *after* delivery.

252. U.C.C. § 2-702(2) provides in part:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply.

Id. § 2-702(2).

253. 11 U.S.C. 547(b)(5) (1988). To be enforceable in a bankruptcy case, a reclamation claim may have to meet the requirements of 11 U.S.C. § 546(c), which in certain respects are more stringent than those of U.C.C. § 2-702(2). I hedged the statement in the text first because of the possibility that the § 2-702(2) reclamation claim might not

tor will have to be diligent in preserving its rights.[254]

The fundamental problem with the suggestion that the creditor who is paid for current expenses somehow deserves to be paid is that it ignores the whole idea of preference law. By definition all contractual unsecured creditors of the debtor gave value to the debtor. At least part of that value may still be in the debtor's estate, even if extended long before the bankruptcy.[255] However, because of the debtor's insolvency, all of these creditors cannot be repaid in full. The question is why *this* current expense creditor should be treated better than those other creditors. A value-added notion does not sufficiently justify the distinction. If the rationale is to encourage last minute prop-ups of a distressed debtor, we again are back to the incentive effect, which is discussed in the next part.

If the transaction between the creditor *C* and the debtor *D* was intended to be and was in fact "substantially contemporaneous" and thus in essence one transaction, then section 547(c)(1) already provides a safe harbor from preference avoidance.[256] Section 547(c)(2) should not be interpreted to effectuate the same purpose, but in a more permissive way. As a basic matter of statutory construction, it is most plausible that Congress intended to implement the one transaction purpose only in the subsection specifically crafted to achieve that end.

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be sustained under § 546(c), in which case there would be a preferential effect. Second, the bankruptcy court under § 546(c)(2)(A) can substitute an administrative priority claim for the reclamation claim, thus creating the possibility that the creditor will not be fully compensated if administrative priority claims are not paid in full. Finally, § 2-702(2) only speaks in terms of actual reclamation of the goods themselves and does not create an independent right of payment. However, the creditor who leaves the goods in the debtor's possession and receives payment in lieu of reclamation could argue that the relinquishment of the reclamation claim was a transfer of equivalent value.

254. A demand for reclamation must be made within 10 days after the buyer's receipt of the goods, unless the buyer made a written misrepresentation of solvency within the preceding three months. U.C.C. § 2-702(2) (1966).

255. *See* Broome, *supra* note 9, at 114; DeSimone, *supra* note 10, at 130.

256. Section 547(c)(1) provides:

> 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.

11 U.S.C. § 547(c)(1) (1988); *see* Dunham & Price, *supra* note 9, at 490, 500-01.

C. *Value Maximization and the Incentive Effect*

1. *The Argument in Favor*

The second justification for the ordinary course exception focuses on the possibility of benefiting the body of creditors as a whole by increasing the total value of the debtor's assets. The argument is something along the following lines.[257] If ordinary course transfers were made subject to avoidance, then creditors would be even more reluctant than they presently are to do business on a credit basis with a financially distressed debtor. The withholding of credit from questionable debtors would inevitably drive more debtors out of business and into bankruptcy.[258]

If, on the other hand, ordinary course transfers are protected, then creditors can safely continue to do business with financially troubled debtors without having to worry that payments received now may have to be disgorged later if the debtor subsequently files bankruptcy. In essence, the ordinary course safe harbor can be characterized as creating or preserving an incentive for creditors to extend credit to distressed debtors.[259] The positive results that supposedly flow from this incentive effect may keep the debtor out of bankruptcy entirely, thus making everybody better off.[260] Even if the debtor does file a Chapter 11 case, it will be in a stronger financial condition when it does so because of the operation of the incentive effect. In either case the basic notion is that even though some creditors are paid a larger percentage share of their claim than others, every creditor ultimately recovers more total dollars because the total asset pie is larger. The exact same

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257. Countryman, *supra* note 9, at 775, characterized the argument as follows:

> If a debtor selectively can meet debts currently coming due in order to continue functioning outside of bankruptcy, creditors should be encouraged to accept these payments, even though preferential. Consequently, creditors may continue doing business with the debtor because they will not be penalized if the debtor's attempt to function outside of bankruptcy fails.

Id. He goes on to say, however, that "[t]his justification is not compelling because it is contrary to the entire concept of preference." *Id.* I agree. *See infra* part IV(C)(2).

258. *See* DeSimone, *supra* note 10, at 100, 106; Orelup, *supra* note 5, at 236. Professor Herbert recognized this as a valid goal, stating that "the trade creditor who, as its buyer drifts towards bankruptcy, enters into an accommodation with the buyer under which the buyer will reduce preexisting obligations in exchange for the creditor's permission to incur new ones, deserves significant protection from the dangers of preference liability." Herbert, *supra* note 40, at 691-92. However, he questioned how effective § 547(c)(2) is in implementing that goal. *Id.* at 672. Furthermore, he noted that it is possible that § 547(c)(2) "was not designed to *encourage* anything—but merely to avoid penalizing unconscious preferences." *Id.* at 670 n.14.

259. *See* Broome, *supra* note 9, at 117.

260. *See* Herbert, *supra* note 40, at 693 n.108.

rationale is used to justify the controversial doctrine of necessity, which authorizes the payment of selected unsecured claims in preference over others during a Chapter 11 case.[261]

A specific subset of the incentive justification relates to the market for commercial paper. Legislative history suggests that one of the principal reasons for the deletion of the forty-five day limitation from section 547(c)(2) in 1984 was to bring issuers of commercial paper within the protective ambit of that safe harbor.[262] The concern expressed was that the forty-five day limit, coupled with the repeal of the requirement that the creditor have reasonable cause to believe that the debtor was insolvent, exposed purchasers of commercial paper falling due within the preference period to recapture. This result was unfair, the argument went, because those issuers were entirely innocent of any opt out motives. As matters stood, the market for commercial paper would dry up. This, in turn, would deprive debtors of a much-needed source of capital and would drive more debtors into bankruptcy.

2. *Critique of the Incentive Effect Justification*

Before turning to a critique of the incentive effect rationale as a whole, I first want to refute the specific argument that relates to protecting the market for commercial paper, which at least in part motivated the 1984 repeal of the forty-five day limitation.[263] There are at least three main problems with that argument. First, it ignores the fact that in the event of a bankruptcy filing a temporal dividing line will be drawn; the only question is where. Second, the argument accepts without question the lending practices of banks. Third, it ignores equality.

If the maturity date of the commercial paper falls *after* the debtor files for bankruptcy, then the holder of the paper is not entitled to payment in full from the debtor. If the paper is backed by an irrevocable letter of credit by a solvent bank, then the holder can look to the bank to be paid. If not, pro rata participation with all other unsecured creditors would be mandated. Accordingly, to obtain favorable rates, a commercial paper issuer usually must have the backing of an irrevocable letter.

However, the argument is that without section 547(c)(2) as it currently reads—or some similar safe harbor—the purchaser of the paper would be worse off if repaid during the preference period than if not repaid at all before bankruptcy. The reason is that payment discharges

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261. *See* Charles J. Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 92-102 (1991).

262. *See supra* note 229 and accompanying text.

263. *See supra* notes 227-29 and accompanying text.

the liability of the bank.[264] Thus, in the event of a prebankruptcy payment during the preference period, the purchaser would have to return the payment, but would not then be able to look to the bank. If payment does not come due until after bankruptcy, however, the bank is still on the hook.

What is not clear is why this problem had to be fixed by insulating the purchasers from preference recapture. Under this solution the money with which the purchasers are paid during the preference period while the debtor was insolvent effectively comes out of the pockets of all of the other unsecured creditors, thus undermining the equality principle. Instead, it would make more sense to have a rule that requires the purchaser of the commercial paper to have to look to the bank for payment, as is the case when the maturity date of the paper falls after bankruptcy. Although the bank issuing the letter of credit currently is discharged by payment, there is no obvious reason why banking practices could not be changed so that the bank would undertake to pay the purchaser in the event of preference recapture.[265]

Let us now consider the broader issue of the validity of the incentive effect justification. The first criticism that can be levied against this justification for the ordinary course exception is that the preference issue comes up only if the debtor in fact goes bankrupt. Thus, by definition the ultimate objective of the incentive effect argument, which is keeping the debtor out of bankruptcy, has not been realized. Outside of bankruptcy a debtor is free to make preferences.

Second, the argument assumes that the legal rule chosen actually will influence the decision of creditors whether to do business on a credit basis with a distressed debtor. I find that assumption extremely questionable. As discussed above, the argument that the preference law deters last-minute grabs has been subjected to severe criticism.[266]

I likewise question the converse proposition—the supposed incentive effect of the ordinary course safe harbor of preference law. I believe and my experience in practice indicates that the creditor's estimation of the likelihood of the debtor's payment on a timely basis dwarfs all other considerations. Whether a debtor will or will not go into bankruptcy, whether a preference action will even be brought if bankruptcy does ensue, and whether such a preference action will be successful if brought are all much more remote concerns than the basic question of whether the debtor will pay. In every credit extension the creditor must consider that problem; the spectre of bankruptcy and preference recapture is much less immediate.

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264. *See* Broome, *supra* note 9, at 103 n.117; Countryman, *supra* note 9, at 771.
265. *See* Countryman, *supra* note 9, at 771.
266. *See supra* notes 39-40 and accompanying text.

Thus, if the debtor truly is in difficult straits, a careful creditor will insist on C.O.D. transactions no matter what the preference law says. The fact that the preference law would permit the creditor to keep any payment that the debtor made on account even if the debtor soon goes bankrupt does not in any way enhance the debtor's liquidity so that the debtor has the money to make that payment. Conversely, a creditor who is willing to take a credit chance in order to make a sale is likely to take that chance whatever the state of the preference law.[267]

Third, even if there is an incentive effect, the model described above is fatally deficient because it assumes that an ordinary course of business exception creates only positive incentives to do business with the debtor. The paradigm ignores negative incentives—namely that a creditor might take into account the possibility that another creditor might get paid in preference to itself and therefore decide not to lend. If all creditors were rational economic actors, they would realize that payments by an insolvent debtor to a group of creditors is a zero-sum game. In other words, given that there is only a limited pool of assets to distribute, payment to one creditor of more than its pro rata share must of necessity come out of the share that otherwise would go to another creditor. No creditor could be certain in advance that they would be the lucky one who got paid. Economically, the percentage of negative incentives should exactly balance out the positive incentives, resulting in no net gain to the debtor in terms of credit made available. This fact is illustrated in the example given below.

Fourth, the standard recitation of the incentive effect assumes that section 547(c)(2) creates a greater incentive for creditors to do business with the debtor and thereby keep the debtor out of bankruptcy than would be true if section 547(c)(2) did not exist. On the contrary, exactly the opposite may be true. Creditors may accept or demand a payment within the preference period in the ordinary course of business and then refuse to conduct further business with the debtor, driving the debtor into bankruptcy. Given section 547(c)(2), those creditors do not have to fear recapture of the payment in bankruptcy. Indeed, section 547(c)(2) creates an incentive for trade creditors to demand timely payment and to refuse to cooperate in a workout.[268] If section 547(c)(2) were repealed, however, and a stricter recovery standard implemented, then creditors would have every in-

267. Although Professor Herbert adopted a theory of preference law with regard to trade creditors diametrically opposed to that urged in this Article, he at least agreed with me that the creditor may be willing (or not) to deal with a troubled debtor for business reasons entirely unrelated to the state of the preference law. Herbert, *supra* note 40, at 695 & n.113.

268. *See* Kraus, *supra* note 18, at 1458.

centive to keep the debtor out of bankruptcy. Only by doing so would the creditors be able to keep their payments.[269]

Fifth, even if the incentive effect really exists and even if it magically results in a positive increment in the amount of credit made available to the debtor, the exception in section 547(c)(4) for subsequent new value already provides for an adequate incentive effect.[270] A creditor who extends new credit to the debtor during the preference period *after* receiving an otherwise preferential transfer is protected from preference liability to the extent of the new value given. The ordinary course of business exception in section 547(c)(2) therefore is important only for creditors who do *not* extend any further credit after being paid off during the preference period. The need to protect these creditors in order to keep the debtor's business going is far from obvious.

A sixth criticism of the standard litany justification of the ordinary course rule is that it ignores the adverse consequences stemming from the application of that rule. Stated another way, that justification necessarily must assume that the benefits obtained from insulating ordinary course transfers from preference avoidance outweighs any costs resulting therefrom. Above I have questioned whether the supposed benefits actually accrue as assumed. Even if they do, however, are they worth the cost?

To answer this question of course necessitates identifying the costs of having a safe harbor for ordinary course transfers. One cost is simple: one creditor gets paid, others do not. The premise of equal treatment of similarly situated creditors is undermined.

Refer back to the example stated at the beginning of Part II. The day before bankruptcy, insolvent debtor *D* pays creditor *A* the full $600 owed, but pays nothing to creditors *B* and *C*. All three creditors had extended credit in the ordinary course of business, and the payment to *A* was made on ordinary credit terms and in the ordinary course of business. What is the result if a preference action is brought?

Without considering the provisions of any particular preference

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269. *Cf.* McLaughlin, *supra* note 27, at 235 (stating that a creditor who is aware that it can be compelled in bankruptcy to disgorge undue advantage is much more likely to cooperate with other creditors); Kraus, *supra* note 18, at 1454-55 (discussing how preference law is a means of encouraging cooperative rather than individual approaches to the debtor's problems).

270. *Cf.* Dunham & Price, *supra* note 9, at 490, 501-02 (explaining how § 547(c)(4) operates to give creditors a setoff against the trustee's preference claim for credit that the creditor extends subsequent to the preference). The overlap between § 547(c)(2) and (c)(4), and the possible use of (c)(4) to protect trade credit extensions to a distressed debtor, are explored in Herbert, *supra* note 40, at 674-78. However, Professor Herbert argues that § 547(c)(4) does not work well to further the incentive effect. *Id.* at 678.

law, fairness would seem to dictate that *A* should have to give back the $600 that *A* received from *D* the day before the bankruptcy filing at a time when *D* was hopelessly insolvent. The trustee then could distribute $200 each to creditors *A*, *B*, and *C*. Otherwise, the end result would be that *A* would receive $600 and *B* and *C* nothing.

However, under section 547(c)(2) of the Bankruptcy Code, creditor *A* almost certainly would not have to disgorge the $600 payment. All of the elements of section 547(c)(2) appear to be satisfied in this example. Thus, the probable result is that *A* gets $600 and *B* and *C* nothing.

Yet, this result ignores the fact that *B* and *C* were equally as worthy as *A* on the very terms of the keep the debtor in business model, for each extended credit to the debtor within the trade cycle immediately preceding bankruptcy. Furthermore, in terms of any incentive effect, the net incentive of the entire group of creditors *A*, *B*, and *C*, was identical to that which would exist absent section 547(c)(2). Assuming perfect knowledge, the creditors would calculate that the likely repayment value package was $200. With section 547(c)(2) the calculation would be ⅓—the chance that each creditor has in advance of receiving and keeping full payment, times $600 (the amount of the payment). Without section 547(c)(2), the calculation would be a 100% chance—even if someone were paid, they would have to give it back—of receiving a ⅓ pro rata share, namely $200.

D. Repose

1. The Argument in Favor

The final normative justification for the ordinary course of business exception approaches the whole issue from a completely different orientation than the current expense and incentive effect justifications. Those rationales attempt to explain as a positive matter why section 547(c)(2) effects a beneficent result. The repose justification operates, however, from the premise that there is nothing to explain. Under this argument those who advocate upsetting settled transactions should bear the affirmative burden of justification.

The baseline assumption is that all prebankruptcy transfers should be left undisturbed. The important policy of finality in commercial transactions is preserved.[271] Economically, this is the lowest cost alternative. Recovering preferences entails administrative and liti-

271. *See* McCoid, *supra* note 2, at 269-70; Charles E. Neider, Note, *Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act*, 1974 WIS. L. REV. 481, 491-92; Orelup, *supra* note 5, at 218.

gation costs for the estate and for the creditor defendant.[272] Professor Morris suggested that "[r]ecovering all of the routine payments made during insolvency and the preceding four month period merely to reallocate these funds between the original recipients and the bankrupt's other creditors would simply not be worth the cost."[273] Similarly, Professors Jordan and Warren observed recently, "If a doctrine designed to obtain equality for all creditors interferes with normal commercial practices and significantly adds to the cost of ordinary commercial transactions, the cost of equality may be too high."[274]

A second cost of preference vulnerability is the uncertainty cost that is inflicted on the creditors.[275] For some potentially extended time period they cannot know whether they will or will not be able to keep payments that they have received from the debtor. This possible exposure to recapture limits the creditor's ability to use the potentially recoverable funds.[276] This uncertainty also has a spillover effect on transactions that involve debtors whose solvency is in doubt.[277]

The repose theory then would assert that no suitable argument can be made for avoiding ordinary course transactions. By definition, the creditor recipients of an ordinary course transfer have done nothing wrong.[278] They have not attempted to opt out of the bankruptcy proceeding.[279] Accordingly, the deterrence rationale underlying the preference law is inapposite.

Some advocates of the repose argument make the further assertion that recognizing and protecting all preferential transfers before bankruptcy is desirable. According to this view, the premise of similarly situated creditors, or of creditor equality, is a myth. Advocates of this view argue that some creditors have more leverage in getting paid than others—a point with which I would agree. They also argue that the fruits of this leverage should, as a matter of economic efficiency, be honored—a point with which I disagree.

2. *Critique of the Repose Justification*

Repose is a potentially legitimate basis for allowing ordinary course transfers to stand. No one would seriously deny that the policy of finality in commercial transactions is important. Parties need to and

272. *See* McCoid, *supra* note 2, at 266-67.
273. Morris, *supra* note 1, at 738.
274. ROBERT L. JORDAN & WILLIAM D. WARREN, BANKRUPTCY 431 (2d ed. 1989).
275. *See* McCoid, *supra* note 2, at 267-69.
276. *See id.* at 267.
277. *See id.* at 267, 270.
278. *See* Morris, *supra* note 1, at 738.
279. *See supra* notes 34-37 and accompanying text.

do rely on the finality of these transactions. Costs are implicated if repose is ignored. In the next section I address the cost issue in connection with the ramifications of repealing the ordinary course exception.

Having said that finality is important, however, one runs the risk of proving too much. If repose really is so critical, then how can we rationalize permitting the recapture of *any* preferential transfers? The most logical conclusion to be drawn from a sincere belief in the importance of finality is that section 547 should be repealed in its entirety. Advocates of the more extreme version of the repose justification, that even admitted opt out behavior by a creditor resulting in a preferential transfer should not be avoided, possibly would agree with repeal. Professor McCoid suggested that abolition might make sense, given the failure of deterrence.[280] He argued that at least then creditors would have an incentive to monitor the behavior of the debtor and other creditors and to precipitate collective proceedings earlier.[281]

An alternative step, which recognizes the importance of repose but stops short of complete abolition of preference law, is to establish an absolute cutoff date prior to the commencement of bankruptcy proceedings beyond which transactions will be secure. This, of course, is what the current preference law does by limiting the preference period for noninsider creditors to ninety days before the bankruptcy filing.[282] Transactions completed prior to that period are totally protected in the interest of finality, even if the debtor was insolvent at the time of the transfer. It has been suggested that all transfers made after insolvency should be subjected to recapture without a limiting time period.[283] This approach completely ignores repose in the interests of intercreditor equality.

The current embodiment of the policy of repose in the ninety day exposure rule does not explain why repose *also* should be applied to protect transactions that occur *within* the short preference period preceding the bankruptcy case. Section 547(c)(2) theoretically would protect an ordinary course transfer that took place an instant before the bankruptcy case was filed. Once one admits, however, that *any* preferential transfers should be recaptured (here within the ninety days) and that repose in and of itself therefore is not the ultimate trump card, the difficulty of establishing a logical and workable premise upon which to sort good from bad preferences arises. The issue is not really about finality anymore.

Instead, the argument has again shifted back to equality versus

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280. *See* McCoid, *supra* note 2, at 270-73.
281. *See id.* at 271-72.
282. 11 U.S.C. § 547(b)(4)(A) (1988).
283. *See* Kraus, *supra* note 18, at 1459.

deterrence. Here the fundamental misconception is that the deterrence rationale is the essence of preference law. The tension between equality and deterrence, and the defects in the deterrence justification, were explicated above.[284] The assumption that the current preference law deters even blatant opt out behavior probably is erroneous.[285] My conclusion was that the defining premise of preference law should be equality of distribution between unsecured creditors after the debtor becomes insolvent. The policy favoring repose does not change that conclusion, unless one is willing to do away with preference law altogether.

V. Ramifications of Repealing Section 547(c)(2)

Whenever one proposes a potentially radical change in the law, as I do in this Article, prudence dictates a careful consideration of the potential ramifications of the course of action propounded. The old maxim that "the cure may be worse than the disease" states a truth that must be confronted. Particularly when one proposes breaking with over two hundred years of virtually unbroken precedent, caution is indicated.

Bearing these caveats in mind, I nevertheless hold to my conclusion that the cure of repealing the ordinary course of business exception is warranted for the disease of unrecovered preferential transfers that create inequality between creditors. In a sense, Parts II and IV of this Article dealt with the ramifications of repealing section 547(c)(2) by considering in the former section the larger goals of preference law and in the latter section the specific justifications for the ordinary course safe harbor.

The most immediate ramification would be that what should be the primary preference policy—equality of distribution between creditors after the debtor becomes insolvent—would be furthered greatly.[286] Under the current scheme section 547(c)(2) undercuts equality to such a degree that it cannot rationally be asserted that the preference law substantially furthers that goal.

Consider the simple example that was stated at the beginning of Part II, in which creditor *A* was paid in full the day before bankruptcy, and creditors *B* and *C* were paid nothing, despite the fact that all three had extended necessary credit in the ordinary course of business. My proposal to repeal section 547(c)(2) would change the result of that hypothetical. Whereas under section 547(c)(2) *A* would get to keep the

284. *See supra* part II.
285. *See supra* notes 35-37 and accompanying text.
286. *See supra* part II.

payment, under the proposed change *A* would have to return the money so that it could be distributed equally to *A*, *B*, and *C*. This, I assert, is a better result.

To the extent one believes that deterrence works, that policy too arguably would be furthered if section 547(c)(2) were repealed. If creditors know that it is more likely that they will have to give back payments received if the debtor goes into bankruptcy within a short time period (and that other unpaid creditors have the power to put them there),[287] then those creditors may be deterred from expending resources to try to obtain those payments. Advocates of section 547(c)(2) would say that grabbers are not protected thereunder because such a grab would not be in the ordinary course of business. However, the reality is that even grabbers have a better chance of keeping a preferential transfer if section 547(c)(2) remains on the books than if it is repealed.[288] Subtle or even not-so-subtle pressures can be levied against debtors to prompt payments, which nevertheless later may be classified as ordinary course. The extensive case law holding that even late payments can be classified as ordinary course[289] suggests how wide the window of opportunity for creditors is and how tempting it is for creditors to ignore the possibility of subsequent recapture under the preference law.

Perhaps more significantly, the transfer of some of the debtor's assets to a few creditors after the debtor becomes insolvent is less likely to trigger a wild scramble for the remainder of the debtor's assets if the remaining creditors are secure in the knowledge that they can instead file an involuntary bankruptcy case and then compel the preferred creditors to give back what they took. Under the current system, however, in which the preferred creditors have a good chance of keeping what they receive because of section 547(c)(2), a mad race to dismember the debtor is more likely to occur.

What are the potential negative consequences of repeal? It is fashionable to project a parade of horribles that would result if section 547(c)(2) were repealed. Usually these center on the loss of incentives that would result—namely a contraction in credit available to financially troubled debtors and a consequent compounding of business failures.[290] The value of the debtor's assets would therefore not be maximized. The drawbacks of the incentive effect were detailed in Part

287. 11 U.S.C. § 303 (1988) (involuntary cases).

288. *Cf.* Kraus, *supra* note 18, at 1456 (stating that a grabber may be able to retain a preferential transfer if it could keep the debtor out of bankruptcy for the statutory period).

289. *See, e.g.*, Yurika Foods Corp. v. United Parcel Serv. (*In re* Yurika Foods Corp.), 888 F.2d 42, 45 (6th Cir. 1989).

290. *See supra* notes 257-60 and accompanying text.

IV(C)(2) above, and I reiterate them here.

The more substantial concern to be addressed if Congress repeals section 547(c)(2) is the deleterious effect on finality and repose. In the preceding section I attempted to point out that, while repose certainly is a matter of valid concern, that policy is furthered primarily by the establishment of the absolute (except for insiders) ninety day limitation on the preference reachback. Within the ninety day period, it makes less sense to focus on finality, in terms of justifying the ordinary course exception itself, or in debating the effects of its repeal.

The chief practical ramification of repealing section 547(c)(2) that must be considered is the cost, which is mentioned above as part of the rationale supporting the repose policy. These costs can be subdivided into litigation costs and uncertainty costs. Litigation costs will be increased in one respect if section 547(c)(2) is repealed for the simple reason that many more transfers will be subject to avoidance. If trustees believe that a preference action has a better chance of success, they are more likely to pursue it. It can be argued that this cost is a net loss overall because all that is accomplished by the preference action is a redistribution of assets from the one preferred creditor to the entire body of creditors.

However, the argument that the ordinary course exception should not be repealed because of increased litigation costs can be rebutted on two levels. First, and most fundamentally, as is true with the repose argument in general, it proves too much. The logical and ultimate conclusion reached if avoidance of litigation costs is identified as the paramount policy determinant is that section 547 should be repealed in its entirety. All preference recaptures entail litigation and other transaction costs, with only a redistributive effect. Because of this, some extremist law and economics advocates suggest repeal of section 547.

The unfairness inherent in validating all preferences, however, leads me, as well as nearly everyone else who has considered the issue, to reject this extreme view. The consistent condemnation of preferences for several hundred years in Anglo-American jurisprudence indicates that total repeal is unlikely. Equality is given weight. If preference law is retained in general, thus indicating that cost savings has not been embraced as the controlling policy, arguing against repeal of section 547(c)(2) on the ground that an incremental savings in litigation cost will be realized loses much of its persuasive force. Drawing a line that allows some transfers to be retained, so that some costs will be saved, but thus undermining equality, smacks of an arbitrary compromise.

Furthermore, I am not even willing to concede that the repeal of section 547(c)(2) will lead to a net increase in litigation costs. The Commission Report identified the reduction of costly litigation as an

important subsidiary goal of preference law reform,[291] and the 1977 House Report likewise concluded that some major preference law reforms were justifiable partly on the basis of saved litigation costs.[292] For example, one of the primary reasons given for eliminating the reasonable cause to believe standard in the 1978 legislation was to reduce the cost of litigating preferences.[293]

Anyone with even a passing familiarity with the realities of preference litigation under section 547(c)(2) knows all too well that little if any improvement over the old law has been obtained.[294] The main issue in almost every preference case involving trade creditors is the application of section 547(c)(2). This is not surprising, given the fact that the ordinary course exception is the conceptual successor to the reasonable cause to believe test, and, more importantly, that the concept of "ordinary course" is inherently quite vague. Any semicompetent creditor's lawyer should be able to present at least a colorable ordinary course defense. The prospect of daunting litigation costs in having to counter an ordinary course argument undoubtedly deters trustees from bringing many potentially meritorious preference actions and influences them to settle many more. If section 547(c)(2) were repealed, however, a very large number of preference cases would be greatly simplified; the creditor would not have even an arguable defense.

If potential litigation and administrative costs in permitting the recapture of every payment made within the ninety days preceding bankruptcy are viewed as simply unacceptable, much less radical alternatives than current section 547(c)(2) are available. One is to reduce the preference period, which is discussed below. By reducing the period of vulnerability, the number of exposed transactions likewise would be reduced.

A second way to reduce unacceptable litigation and administrative costs would be to extend the small preference exception of section 547(c)(7) to business debts as well. Such a comprehensive small preference exception had been proposed by the Bankruptcy Commission for all transfers to noninsiders for less than $1000.[295] The Commission justified this proposal on the grounds that "[r]elatively small preferences do not seriously impinge on the goals of [preference law]. In addition, the expense of recovery is often disproportionate to the benefit to cred-

291. *See* COMMISSION REPORT, *supra* note 197, pt. I, at 201, 204.

292. *See* HOUSE REPORT, *supra* note 5, at 178.

293. *See id.*

294. *See also* DeSimone, *supra* note 10, at 96 ("The 1984 change expanded the scope of 547(c)(2), but it will not, at least initially, reduce the amount of litigation.").

295. *See* COMMISSION REPORT, *supra* note 197, pt. II, § 4-607(b)(1), at 166; *see also* Neider, *supra* note 271, at 493-94.

itors."[296] The National Bankruptcy Conference suggested a smaller $500 exclusion, while the National Conference of Bankruptcy Judges and the Justice Department rejected the proposal in favor of leaving the whole matter of litigation efficiency to the discretion of the trustee.[297]

Congress in 1978 chose to follow the latter course, but then added the $600 consumer exception in 1984 in response to lobbying by the consumer credit industry. Professor Countryman aptly pointed out that section 547(c)(7) is hard to justify in conjunction with the expanded protection available under section 547(c)(2).[298] I would prefer on the whole to repeal section 547(c)(7) and defer to the discretion of the trustee in individual cases. If, however, cost concerns concomitant with a repeal of section 547(c)(2) are simply too horrifying to contemplate, then I would suggest a comprehensive (*i.e.*, for all types of debts) small preference exception. The specific dollar amount chosen is not something I am overly concerned with, but something in the range of $500 to $1000 would be plausible.

The uncertainty costs involved in allowing preference recapture, also discussed as part of the repose argument,[299] must be dealt with as well in considering the repeal of the ordinary course exception. Abolishing section 547(c)(2) arguably will increase these uncertainty costs because of the increased likelihood of preference recapture. The effect may be that any payment received cannot be finally credited on the books and then committed to other uses until ninety-one days after receipt.

However, the potential incremental negative effect on these uncertainty costs resulting from repealing section 547(c)(2) may be exaggerated. A creditor who has received a payment and is deciding whether to invest that money, but who wants to take into account the possibility of preference recapture, first must discount substantially the probability of that possibility by the likelihood that a bankruptcy case will not be filed within ninety days. This, I submit, is by far the most significant projection made and relied upon by the creditor (to the ex-

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296. COMMISSION REPORT, *supra* note 197, pt. I, at 206. The notes accompanying the draft Act stated:

> Its primary purpose is to eliminate litigation to recover property where the actual return to creditors is nominal after deduction of the cost of recovery. A secondary purpose is to soften the impact of other changes, including the elimination of the requirement that a creditor had reasonable cause to believe the debtor to be insolvent.

Id. pt. II, at 170 n.11.

297. *See* Countryman, *supra* note 9, at 813-14.

298. *See id.* at 814.

299. *See supra* notes 275-77 and accompanying text.

tent the creditor considers the possibility of preference recovery in bankruptcy at all). If the creditor does not think it likely that a bankruptcy case will be filed within ninety days, then the creditor probably will decide to go ahead and commit the funds received from the debtor, no matter what the state of the preference law. If this is true, then changing the law to increase the likelihood of preference recovery in the event bankruptcy is filed within ninety days and a preference action is brought should not have a significant incremental effect on the creditor's decisionmaking process. Furthermore, the differential impact on the creditor's uncertainty may not be substantial if section 547(c)(2) is repealed, since even with that exception the creditor cannot be sure to avoid preference recapture.

If the uncertainty cost nevertheless is determined to be unbearable, that cost could be reduced substantially by shortening the ninety day preference period, say to forty-five days.[300] Then creditors could know with absolute confidence that they would be permitted to keep all payments received over forty-five days ago. The forty-five day period is used elsewhere in commercial law as an indicator of a reasonable exposure period.[301] The uncertainty cost could be further reduced if a comprehensive small preference exception were enacted. Adoption of a forty-five day preference period also would reduce litigation costs by decreasing the number of exposed transactions, as pointed out above. At the same time, the increased certainty in and simplicity of preference lawsuits actually brought (and thus reduced costs) stemming from repeal of section 547(c)(2) would be preserved.

My proposal to repeal section 547(c)(2) does not in any way stand or fall with the modest proposal to reduce the preference period to forty-five days for noninsiders or possibly to expand the scope of the small preference exception. As discussed in detail throughout the Article, I believe that the supposed benefits of current section 547(c)(2) are greatly overstated, as are the predicted harm from that subsection's repeal. Even if it is concluded that the preference period should re-

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300. The idea of coating the pill of eliminating a significant escape hatch for creditors by reducing the preference period is not new. For example, Professor MacLachlan suggested:

> A possible compromise which has not yet received deliberate consideration in this country might be to upset preferences within a period of ten or thirty days prior to bankruptcy, without reference to the knowledge or belief of the transferee. This would simplify the task of the trustee in cases of denuding the estate at the eleventh hour without upsetting bona fide transactions over an intolerable period.

JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 269, at 311 (1956).

301. The interplay between the federal tax lien and a security interest arising out of a commercial financing arrangement is a prominent example. *See* 26 U.S.C. § 6323(c)-(d) (1988); U.C.C. § 9-301(4) (1972).

main at ninety days and that section 547(c)(7) should not be expanded, I nevertheless remain adamant that section 547(c)(2) should be repealed.

VI. CONCLUSION

In this Article I have suggested that the true nature of preference law should be seen as akin to strict liability. The discriminatory result is the important fact. After the debtor becomes insolvent, one creditor gets paid, and others do not. Fault-based criteria make little sense. Supporters of section 547(c)(2) must bear the burden of explaining why inequality, even in the absence of opt out behavior, should be countenanced by the bankruptcy preference laws. I do not believe that such a case can be made and therefore believe that section 547(c)(2) should be repealed.

Any attempt to differentiate between preferences in this context is, I believe, largely doomed to failure. Identifying the proper criteria for sorting between good and bad preferences, and then fairly implementing those criteria, has proven an elusive task at best for over two centuries. Recent history alone under the reform efforts of the 1970s and 1980s illustrates the daunting problem of the "me-too" syndrome. Once some creditors are freed from the constraints of the preference law, then all the others are clamoring for like relief, with notable success.

Ultimately, one policy of preference law must predominate. Equality after insolvency as a model is fairest to all creditors, economically most efficient, and logically most convincing. The current expense justification for the ordinary course rule proves both too much and too little. The incentive effect is, I believe, devoid of persuasive force. Repose does have some merit, at least for transactions that substantially predate the commencement of the collective proceeding. A system that recognizes repose through a limited cutoff requirement, but then gives primacy to equality for transactions made after that date, is the one endorsed by this Article.

In *The Spirit of Laws* Montesquieu wrote, "The freedom of commerce is not a power granted to the merchants to do what they please; this would be more properly its slavery. The constraint of the merchant is not the constraint of commerce."[302] So too we should not by section 547(c)(2) of our preference law give merchants virtual carte blanche to aggrandize themselves at the expense of others. The guiding principle of the preference law should be the spirit of equality.

302. BARON DE MONTESQUIEU, 1 THE SPIRIT OF LAWS, Book XX, ch. XII, at 373 (Thomas Nugent trans., Robert Clarke & Co. 1873).