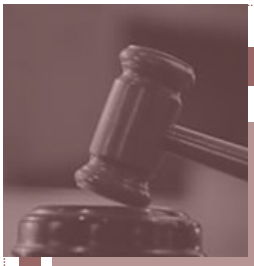

Bankruptcy Litigation Committee

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Pizza or Sausage? Determining the Relevant Industry for Ordinary Business Terms under Bankruptcy Code § 547(c)(2)(B)

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When faced with a preference suit under § 547 of the Bankruptcy Code, one of the most common defenses raised by defendants is the ordinary course of business defense codified in § 547(c)(2). Following the 2005 amendments to the Bankruptcy Code, this defense protects transfers:

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

As the amendment to the Code changed the test from the conjunctive, which required a defendant to meet both prongs (A) and (B), to the disjunctive, the test now only requires a defendant to meet either of the two prongs.[3]

Under prong (A), the "subjective test," courts analyze the conduct between the debtor and defendant to determine whether the challenged transfers were made in the "ordinary course of business."[4] Under prong (B), the "objective test," courts analyze industry terms to determine whether the challenged transfers were made consistent with such terms.[5] While there is case law addressing both prong A and prong B, there is a dearth of precedent explaining which industry must be examined under the objective test.

The leading case cited by most courts in determining ordinary business terms is *Tolona Pizza*.[6] In *Tolona Pizza*, the Seventh Circuit set forth that ordinary business terms are "the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealing so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope" of ordinary business terms.[7] While that often-cited quote appeared to focus solely on the industry of the creditor, the Seventh Circuit muddied the waters by asking, "is [the industry], here, the sale of sausages to the makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?"[8] As in that case, where the defendant sold sausages and the debtor was a pizza-maker, the court was essentially asking: Is the proper industry solely the debtor's industry, solely the creditor's industry or the intersection of the two? Ultimately, the Seventh Circuit never answered its own question and simply held that the industry standards were met.[9]

Post-*Tolona Pizza*, the Second, Third and Fifth Circuits have issued decisions that suggest that one does not look solely to either the debtor's or the creditor's industry, but rather to a combination of the two.

- **Second Circuit**: To properly apply the ordinary business terms standard, the court should look to "those terms employed by similar situated debtors and creditors facing the same or similar problems."[10]
- **Third Circuit**: For "a creditor [to] prove that the debtor made its pre-petition preferential transfers in harmony with the range of terms prevailing as some relevant industry's norm," there must be evidence regarding "the range of terms on which firms comparable to [the creditor] on some level provide credit to firms comparable to the debtor on some level. "[11]

- **Fifth Circuit**: "[F]or an industry standard to be useful as a rough benchmark, the creditor should provide evidence of credit arrangements of other debtors and creditors in a similar market, preferably both geographic and product."[12] Specifically, a defendant may introduce evidence of "credit practices between suppliers to whom [the debtor] might reasonably turn for its seafood supply and firms with whom [the defendant might] compete for customers."[13]

Although the circuit courts have all provided general guidance on the industry analysis, published bankruptcy court decisions offer the best examples of which actual industries have been reviewed. While bankruptcy court decisions can sometimes give the appearance that the court only looked to either the debtor's industry or the creditor's industry, not the intersection of the two, an examination of the underlying facts of those cases reveal that it might not have mattered which industry the bankruptcy court examined because the debtor and creditor were in the same or similar industries.

For instance, in *AboveNet Inc. v. Lucent Techs. Inc. (In re Metromedia Fiber Networks Inc.),* the New York Bankruptcy Court stated that the objective prong "focuses on general practices in the industry, in particular the industry of the creditor. "[14] However, in that case, the debtor provided fiber-optic infrastructure and high-bandwidth Internet connectivity, while the defendant was a manufacturer and provider of telephone communications products and equipment.[15] Accordingly, since there was a great overlap between the debtor's and creditor's industries, focusing on the creditor's industry was likely no different than focusing on the intersection between the debtor's and creditor's industries.

In *McCord v. Venus Foods (In re Lan Yik Foods Corp.),* the bankruptcy court held that the objective prong requires "that the subject payments were 'ordinary' in relation to the prevailing standards in the creditor's industry."[16] In *Lan Yik*, the debtor's and creditor's industries were practically identical, as the debtor was a distributor of Chinese food products and the creditor was a manufacturer and supplier of Chinese food products. Thus, the court's use of the creditor's industry likely encompassed the debtor's industry as well.

Likewise, in *Berger Indus. v. Artmark Prods. Corp. (In re Berger Indus.)*, the court stated that the objective prong requires "proof that the subject payments were ordinary in relation to the prevailing practices in the creditor's industry."[17] As the debtor was a manufacturer of electrical components and the creditor was an importer of industrial components,[18] there may have been very little meaningful difference between the two industries.

Conclusion

As the Second Circuit held, "[d]efining the relevant industry is appropriately left to the bankruptcy courts to determine as questions of fact heavily dependent upon the circumstances of each individual case."[19] Practitioners should bear this in mind when litigating an ordinary-business-terms defense and should look to decisions specific to the circuit, district and judge handling their adversary proceeding, as well as the facts and circumstances of their case to determine the correct industry to analyze.

1. The views expressed in this article are those of the authors and may not reflect the views of the firm.

2. 11 U.S.C. § 547(c)(2).

3. *Goldstein v. Starnet Capital Group LLC (In re Universal Mktg.)*, 481 B.R. 318, 325 (Bankr. E.D. Pa. 2012).

4. *Wahoski v. Classic Packaging Co. (In re Pillowtex Corp.)*, 427 B.R. 301, 307 (Bankr. D. Del. 2010).

5. *In re Universal Mktg.,* 481 B.R. at 326.

6. 3 F.3d 1029 (7th Cir. 1993).

7. *Id*. at 1033.

8. *Id.*

9. *Id.*

10. *Lawson v. Ford Motor Co. (In re Roblin Indus.),* 78 F.3d 30, 42 (2d Cir. 1996).

11. *Fiber Lite Corp. v. Molded Acoustical Products Inc. (In re Molded Acoustical Products Inc.),* 18 F.3d 217, 226 (3d Cir. 1994).

12. *Gulf City Seafoods Inc. v. Ludwig Shrimp Co. (In re Gulf City Seafoods),* 296 F.3d 363, 369 (5th Cir. 2002).

13. *Id.*

14. 2005 Bankr. LEXIS 3168, at *17 (Bankr. S.D.N.Y. 2005).

15. *Id.* at *4-5.

16. 185 B.R. 103, 114 (Bankr. E.D.N.Y. 1995).

17. 260 B.R. 639, 648(Bankr. E.D.N.Y. 2001).

18. *Id.* at 641.

19. *Roblin Industries*, 78 F.3d at 40.