THE ORDINARY COURSE OF BUSINESS DEFENSE IN BANKRUPTCY PREFERENCE ACTIONS: METHODS OF COMPARISON

ABSTRACT

One of the most uncertain and undefined sections of the Bankruptcy Code is Section 547(c)(2), dealing with the ordinary course of business defense. Section 547 of the Bankruptcy Code allows courts to review certain payments made by the debtor within ninety days prior to a debtor filing for bankruptcy. This period is called the preference period. A preference action seeks to claw back the payments made by the debtor during the preference period, however, a creditor can defeat a preference action by raising one of the avoidance defenses enumerated in Section 547(c).

Specifically, the uncertainty surrounding the ordinary course of business defense stems from which method of comparison should be used, and the circuits are split as to the use of either the average approach or the range approach. The average approach compares the average of the transactions made in the preference period to the average of the transactions in the pre-preference period to determine if the payments were consistent. In comparison, the range approach compares the range of the transactions made during the preference period to the range of transactions in the pre-preference period.

This Note provides an in-depth analysis and comparison of the average and range approach, specifying the strengths and weaknesses of each. This Author then advances a new embellishment to the range approach that will help eliminate ambiguity in the ordinary course of business defense. Briefly, this Author argues that a statistical method known as "trimming" should be used to eliminate aberrant transactions, and that the pre-preference period range should be computed without these transactions. This will result in a more accurate depiction of the business relationship between the debtor and creditor, while also providing clarity and certainty in the ordinary course of business defense.

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I. INTRODUCTION

"Not only is the preference provision the most litigated of bankruptcy's avoiding powers, it can unwind a host of settled commercial transactions."[1] In preference litigations, one of the most inconsistent and unsettled areas is the ordinary course of business ("OCB") defense.[2] The uncertainty surrounding the OCB defense derives from which method of analysis should be utilized when comparing pre-preference transactions to transactions made within the preference period; bankruptcy courts utilize either the range approach or the average approach, and the circuits

[1] DAVID WHEELER, ABI PREFERENCE HANDBOOK 3 (Am. Bankr. Inst. 2002); Dorman Wood, Bankruptcy Preference Defence: *Expert Witness v. Expert Witness* (2005), *available at* http://www.expertlaw.com/library/bankruptcy/preference_defense.html.

[2] *See* 11 U.S.C. § 547(c)(2) (2006). While researching the ordinary course of business defense to preference actions and speaking with attorneys in the field, a bankruptcy attorney from a prominent law firm stated that when he sees an ordinary course of business defense in a bankruptcy preference action, his first instinct is to settle the case because courts have not provided consistent holdings in this area. When attorneys are apprehensive to litigate a specific action due to uncertainty, the law is clearly not defined well enough.

are currently split as to which method should be used.[3] The controversy over which method of comparison should apply was recently highlighted by the June 2012 Delaware Bankruptcy Court decision issued by the Honorable Judge Sontchi, in *In re American Home Mortgage Holdings, Inc.*[4]

The heart of the court's decision in *American Home Mortgage Holdings, Inc.* focused on whether the preference payments at issue differed from the amount usually paid.[5] Stated differently, were the preference payments protected by the ordinary course of business defense?[6] To resolve this issue, the court compared payments made by the debtor during the pre-preference period to those payments made during the preference period.[7] However, the parties took divergent views with respect to the methods of comparison that should be used, *i.e.*, the range approach or the average approach.[8] Ultimately, the court rejected the plaintiffs' average approach argument, concluding that the preference payments made by the debtor were within the range of transactions, thus falling within the OCB defense.[9]

This recent decision highlights the uncertainty surrounding the OCB defense in the Delaware bankruptcy bar, especially since the Third Circuit has endorsed the use of the range approach.[10] However, the uncertainty surrounding the application of the OCB defense extends to every circuit in the nation.[11] As of the date of this Note, five circuits have endorsed some form of the range approach, and five circuits continue to use the average approach exclusively.[12] Considering the even split in the circuits and the exponentially growing number of

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[3] *See infra* Part III.C-D.

[4] Sass v. Vector Consulting, Inc. (*In re* Am. Home Mortg. Holdings, Inc.), 476 B.R. 124 (Bankr. D. Del. 2012).

[5] *Id.* at 137.

[6] *Id.* at 137-39.

[7] *Id.* at 137-38.

[8] *In re Am. Home Mortg. Holdings, Inc.*, 476 B.R. at 137-38. The plaintiffs argued for the use of the average approach whereas the defendants argued for the use of the range approach. *Id.*

[9] *Id.* at 137.

[10] *See* Fiber Lite Corp. v. Molded Acoustical Prods. Inc. (*In re* Molded Acoustical Prods. Inc.), 18 F.3d 217, 224 (3d Cir. 1994).

[11] *See* Lawrence Ponoroff & Julie C. Ashby, *Desperate Times and Desperate Measures: the Troubled State of the Ordinary Course of Business Defense—And What to Do About it*, 72 WASH. L. REV. 5 (1997).

[12] As will be discussed *infra* Parts III.C and III.D, the Second, Fifth, Sixth, Eighth, and Eleventh Circuits use the average approach; the Third, Fourth, Seventh, Ninth, and Tenth Circuits use the range approach.

bankruptcy petitions filed since 2008 (in large part due to the economy), it is imperative that this uncertainty be promptly resolved.[13]

To provide context, this Note begins by discussing general bankruptcy policies, preference actions, OCB concepts, and policy considerations imputed in these areas.[14] Second, this Note examines the two methods of comparison commonly utilized by courts when evaluating the OCB defense, namely, the range approach and the average approach.[15] Third, this Note identifies the limitations of these approaches and provides potential modifications to improve the accuracy of both tests.[16] Finally, in an attempt to resolve the ambiguity and solidify the circuits, this Note suggests that bankruptcy courts adopt a trimmed range approach to first identify the existence of aberrant transactions, and to second, provide a remedy for the distortions these unusual transactions cause.[17]

II. BACKGROUND AND BASIC LEGAL CONCEPTS

Ordinarily, borrowers may favor some creditors over others.[18] For example, parties outside of bankruptcy may freely decide which of their debts they wish to pay, how much to pay, and the manner of payment.[19] This freedom to prefer some creditors over others, however, ceases once a debtor files for bankruptcy relief.[20] To this effect, the Bankruptcy Code (the "Code") allows courts to review certain payments made by the bankrupt debtor within ninety days (or one year for those deemed "insiders"[21]) prior to a debtor's bankruptcy declaration.[22] This

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[13] *See generally Bankruptcy Statistics*, U.S. COURTS, http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx (last visited Feb. 26, 2013).

[14] *See infra* Part II.

[15] *See infra* Part III.C-D.

[16] *See infra* Part IV.

[17] *See infra* Parts IV.B & V.

[18] *See* J. Henk Taylor & Justin Henderson*, When Can a Trustee Claw Back Payments to Creditors?*, 19 BUS. L. TODAY 60, 62 (2009).

[19] *See id.* at 60.

[20] *See id.*

[21] *See* 11 U.S.C. § 547(b)(4)(B) (2006). 11 U.S.C. § 101(31) states the term "insiders" encompasses:

> (A) if the debtor is an individual—(i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control;
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> (B) if a debtor is a corporation—(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the

ninety day (or one year) period is referred to as the "preference period."[23] A preference action, most often initiated by a creditor's committee or a trustee, seeks to recover the payments made by the debtor during the preference period and is common in bankruptcy courts.[24]

A. *Policy Underlying the Bankruptcy Code and Preference Actions*

Preference actions are designed to preserve a fundamental policy underlying the Code—that is, to create benefits and incentives for both creditors and debtors.[25] The primary benefit of the Code ensures that all creditors are treated equally and receive a fair distribution of assets from a debtor, while maintaining the enterprise's value for the benefit of all parties in interest.[26] In other words, theoretically creditors do not have to worry that a debtor, prior to filing for bankruptcy, will selectively pay off some creditors with its remaining assets, and leave nothing for the rest.[27] From a debtor prospective, the Code provides an efficient, expedient bankruptcy process and facilitates a debtor's potential emergence from debt.[28]

Preference provisions are intended to maintain normal debtor-creditor relationships prior to a debtor filing for bankruptcy and prevent

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debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if a debtor is a partnership—(i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were a debtor; and

(F) managing agent of the debtor.

[22]*See* 11 U.S.C. § 547(b)(4)(A) (2006).

[23]*See* Peter I. Tsoflias, In Re American Home Mortgage Holdings, Inc.: *Applying The Ordinary Course Of Business Defense To Preference Actions* (2013), *available at* http://www.ferryjoseph.com/in-re-american-home-mortgage-holdings-inc-applying-the-ordinary-course-of-business-defense-to-preference-actions/.

[24]*See id.*

[25]*See* 11 U.S.C. § 547(b)(1) (2006).

[26]*See id.*; *see also* Taylor & Henderson, *supra* note 18, at 60.

[27]*See generally* 11 U.S.C. § 101 (2006) (attempting to treat similarly situated creditors equally). Generally speaking, secured creditors will be paid first, and unsecured creditors come after; however, the ordinary course of business exception protects certain transactions regardless of seniority of interest. *See* Taylor & Henderson, *supra* note 18, at 62.

[28]*See* Century Indem. Co. v. Congoleum Corp. (*In re* Congoleum Corp.), 426 F.3d 675, 682, 686 (3d Cir. 2005).

unusual collection practices that would frustrate the Code's equal treatment goals.[29] Maintaining normal business relationships allows debtors to continue their business or emerge from bankruptcy, while also encouraging creditors to continue doing business with a debtor during their slide into bankruptcy.[30] Preference actions are also in line with the general bankruptcy policy of fairness and equality.[31] Protecting ongoing business relationships gives debtors an opportunity to emerge from bankruptcy, while also giving creditors confidence to continue their relationship with the strained debtor with the knowledge that they will all be treated equally, and do not have to concern themselves about the distribution of a debtor's assets.[32]

B. *Preference Defenses and the Ordinary Course of Business Defense*

A successful preference action results in the preferred creditor returning the funds that were received during the preference period.[33] Once a preference action is initiated, section 547 of the Code allows a defendant creditor to defeat the preference action by proving that the preference payments fell under one of the enumerated defenses listed in

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[29] *In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 224 (3d Cir. 1994).

[30] *Id.* at 225; *see also In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032 (7th Cir. 1993) (stating "[t]he purpose of the preference statute is to prevent the debtor during his slide toward bankruptcy from trying to stave off the evil day by giving preferential treatment to his most importunate creditors, who may sometimes be those who have been waiting longest to be paid"). By not allowing a debtor to favor creditors, creditors may fear that one or a few "[creditors] are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable." *Id.*

[31] *See Tolona Pizza Corp.*, 3 F.3d at 1032.

[32] *Id.*

[33] 11 U.S.C. § 547(b) (2006) sets forth six elements of a preferential transfer that must be shown by the plaintiff:

> (1) The existence of a transfer;
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> (2) The transfer is for the benefit of the creditor;
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> (3) The transfer must be on account of a prior existing debt;
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> (4) The debtor must have been insolvent at the time of the transfer;
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> (5) The transfer must be 90 days prior to the filing of the debtor's bankruptcy (or one year if the creditor is an "insider" as defined by bankruptcy law); and
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> (6) The transfer must have enabled the creditor to receive more than the creditor would have otherwise received if the case was a chapter 7 bankruptcy, the transfer had not been made, and the creditor received payment of its debt to the extent provided under chapter 7.

the Code.[34] Of the section 547(c) defenses available to defendants, the OCB defense (as set forth in section 547(c)(2))[35] is relatively undefined and unsettled.[36] Section 547(c)(2) states:

> (c) The trustee may not avoid under this section a transfer--
> (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was--
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
> (B) made according to ordinary business terms.[37]

The primary purpose of the OCB defense is to promote the continuation of business between creditors and debtors.[38] The OCB exception allows creditors to continue their relationships with a debtor before the debtor files a bankruptcy petition by assuring creditors that their payments will not be clawed back through the initiation of preference actions, provided that they were made in the proper manner.[39] Encouraging creditors to continue their relationship with a strained debtor can help the debtor avoid filing for bankruptcy by continuing their business without interruptions.[40]

This defense only protects "recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee."[41] By protecting only ordinary transactions, the OCB defense encourages normal financial relations and discourages unusual actions by both debtors and creditors.[42] For

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[34]*See* 11 U.S.C. § 547(c) (2006). These defenses include: The Ordinary Course of Business Defense, the Contemporaneous Exchange Defense, the New Value Defense, the Post-Petition Events Defense, the Critical Vendor Defense, the Assumption of an Executory Contract Defense, and the Preservation of a Preference Action in the Plan Defense. *Id.*

[35]11 U.S.C. § 547(c)(2).

[36]*See infra* Part III.B-D.

[37]11 U.S.C. § 547 (c)(2).

[38]*In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 224-25 (3d Cir. 1994).

[39]*Id.*

[40]*Id.* at 225.

[41]ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY 547.04[2], 547-51 (16th ed. 2012).

[42]M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at

instance, if a creditor or trustee proves that a debtor is in some way preferring one creditor over another, those transactions will not be protected by this defense because the transactions were not made in the ordinary course of the debtor's business.[43] In other words, if a debtor, in anticipation of bankruptcy, decides to pay (or is coerced to pay) one creditor at the expense of another, this payment will likely be clawed back.[44] Overall, the purpose of the preference section is to allow a debtor to continue their normal business practices during the slide into bankruptcy, and to allow creditors to continue this relationship while protecting them from underhanded dealings.[45]

III. ANALYSIS

A. *Section 547(c)(2)(A) and (B)*

Section 547(c)(2)(A), referred to as the "subjective" or "vertical" prong, evaluates the relationship between a debtor and its creditors.[46] Under section 547(c)(2)(A), courts compare the pre-preference transactions of the parties with transactions occurring during the preference period to determine if all transactions are consistent—that is, whether the parties changed their credit arrangement from the pre-preference period to the preference period.[47] The pre-preference practices establish a baseline of the ordinary course of business for the dealings between the parties.[48] Transactions made between parties during the preference period are then compared to this baseline to determine if the preference transactions were made in a similar manner.[49]

Section 547(c)(2)(B), known as the objective prong, requires that the challenged payments be "made according to ordinary business terms."[50] This requires courts to compare the relationship of the creditor and debtor to other similar relationships within the same industry.[51]

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*3 (Bankr. S.D.N.Y. Nov. 4, 2010).

[43] *See, e.g.*, Kleven v. Household Bank F.S.B., 334 F.3d 638, 641-42 (7th Cir. 2003).

[44] *Id.*

[45] *In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 224-25 (3d Cir. 1994).

[46] Moltech Power Sys., Inc. v. Tooh Dineh Indus., Inc. (*In re* Moltech Powers Sys., Inc.), 327 B.R. 675, 680 (Bankr. N.D. Fla. 2005).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *See* 11 U.S.C. § 547(c)(2)(B) (2006); *see also* Taylor & Henderson, *supra* note 18, at 62 (discussing why § 547(c)(2)(B) is referred to as the objective prong).

[51] *In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032-33 (7th Cir. 1993).

However, defining an industry standard can be difficult for two reasons.[52] First, it is problematic to identify which industry's norms should govern.[53] Second, business-specific factors, such as size, billing practices, and ongoing business relationships can skew the data.[54] The wide variations in practice areas across different industries make it extremely onerous to determine the industry standard without forcing businessmen to agree on a common set of practices.[55]

For example, suppose a debtor purchases one hundred widgets every thirty days, pays one hundred dollars in cash per widget during the pre-preference period, and continues to purchase the same amount of widgets per month, at the same price and in the same manner, during the preference period. Recall under the subjective prong, courts compare the business practices between a debtor and the creditor during the pre-preference period to their practices during the preference period in order to determine if there are any irregularities.[56] Also remember that under the objective prong, courts compare the debtor-creditor relationship to the practices of other similar relationships in the industry.[57]

This illustration is oversimplified, as courts examine other factors aside from amount, timing, and cost, including:

> (1) the length of time the parties engaged in the type of dealing at issue; (2) whether the subject transfers were in an amount more than usually paid; (3) whether the payments at issue were tendered in a manner different from previous payments; (4) whether there appears to have been an unusual action by the debtor or creditor to collect on or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as gain additional security) in light of

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[52]The court in *Tolona Pizza* described the difficulty of identifying the industry norm in the case at bar, where a debtor's business was making pizzas and asked, "is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?" *Id.* at 1033. While seemingly minor distinctions, the court believed that the variations within each of those industries would result in different conclusions when applied. *Id*.

[53]*Id.* "The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market." *Id.*

[54]*Tolona Pizza Corp.*, 3 F.3d at 1033.

[55]*Id.*

[56]*See* 11 U.S.C. § 547(c)(2)(A) (2006).

[57]*See* 11 U.S.C. § 547(c)(2)(B).

the debtor's deteriorating financial condition.[58]

The plaintiff carries the initial burden of proof to show that a preferential transaction exists.[59] After the plaintiff shows a preferential transaction, the defendant carries the burden of proving the OCB defense by a preponderance of the evidence.[60] The amendments contained in the Bankruptcy Abuse Prevention and Consumer Protection Act in 2005 changed the application of this defense.[61] Previously, defendants had to prove the transfers were made under section 547(c)(2)(A) *and* section 547(c)(2)(B), now they only must prove (A) *or* (B), thus making the standard easier for defendants to meet, and giving businesses more freedom to engage in different creditor and debtor relationships.[62]

B. *Methods of Analysis*

Courts primarily use three different tools in their analysis of the objective and subjective prongs: (1) averages, (2) ranges, and, less commonly, (3) percentages.[63] For averages, courts compute the mean for each of the above listed factors and compare the average of the pre-preference period transactions to the average of the preference period transactions.[64] For ranges, the courts compare the range of the pre-preference period to the range of the preference period.[65] Finally, courts applying the percentage approach look at "the percentage that certain types of transactions took place between the parties [or in the

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[58]*See In re* Am. Home Mortg. Holdings, Inc., 476 B.R. 124, 135-36 (Bankr. D. Del. 2012).

[59]*See supra* note 33 and accompanying text.

[60]Lawson v. Ford Motor Co. (*In re* Roblin Indus. Inc.), 78 F.3d 30, 39 (2d Cir. 1996). Note that the plaintiff carries the initial burden of proof when initiating the preference action. *See id*. at 34. The burden of proof switches to the defendant to prove any of the defenses. *See id.* at 39.

[61]M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at *2 (Bankr. S.D.N.Y. Nov. 4, 2010).

[62]*Id*; *see also* Taylor & Henderson, *supra* note 18, at 62 (stating that the 2005 amendments made the Code more debtor friendly by decoupling the elements of the defense. Since the preferred creditor no longer needs to prove both prongs and can prevail by only proving one or the other, the standard is easier to meet. A lower standard for debtors gives them more freedom when developing and maintaining their relationships with creditors.).

[63]*In re* Moltech Power Sys., Inc., 327 B.R. 675, 681 (Bankr. N.D. Fla. 2005). It is important to note that many times percentages are used in addition to using the range or average approach, and rarely, if ever, used independently. *See id.*

[64]*Id.* at 680-81.

[65]*Id.* at 681.

industry]."[66] The circuits are currently divided on which of these tools to use, and there are no guidelines on when and how each technique should be applied.[67] This Note deals with comparisons of the two most commonly used techniques, average and range.[68]

C. *The Average Approach*

Currently, the average approach has been endorsed by the courts in the Second,[69] Fifth,[70] Sixth,[71] and Eighth[72] Circuits. This approach is the original approach for computation in preference actions.[73] Again, this approach compares the averages (of the above-listed factors) of the pre-preference period transactions to the average of preference period transactions looking for abnormalities.[74] A court will declare that a payment is abnormal and preferential if there is a significant disparity between the averages of these transactions.[75]

Proponents of the average approach look beyond the language of section 547, stating that the purpose of preference defenses supports the use of averages because creditors must demonstrate "some consistency with other business transactions between a debtor and the creditor."[76] Further, the exceptions in section 547, including the ordinary course of

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[66]*Moltech Power Sys., Inc.*, 327 B.R. at 681.

[67]*In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1031 (7th Cir. 1993).

[68]This Note focuses solely on range and average for two reasons. First, no circuit has declared that it uses percentages as its primary form of analysis, and courts choose between using either the range approach or the average approach. *See, e.g.*, *In re* Molded Acoustical Prods. Inc., 18 F.3d 217 (3d Cir. 1994); M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449 (Bankr. S.D.N.Y. Nov. 4, 2010); Hassett v. Altai, Inc. (*In re* CIS Corp.), 214 B.R. 108 (Bankr. S.D.N.Y. 1997). Second, percentages are rarely used by themselves, and more often are used to support either range or averages. *See Moltech Power Sys., Inc.*, 327 B.R. at 681.

[69]*See M. Fabrikant & Sons*, 2010 WL 4622449, at *3.

[70]*See* G.H. Leidenheimer Baking Co. v. R. Patrick Sharp III (*In re* SGSM Acquisition Co. LLC), 439 F.3d 233, 239 (5th Cir. 2006).

[71]*See* Thompson Boat Co. v. Volvo Penta of the Americas, 1999 U.S. App. LEXIS 3440, at *6 (6th Cir. Feb. 25, 1999).

[72]*See* Gulfcoast Workstation Corp. v. Peltz *ex rel.* Bridge Info. Sys., Inc. (*In re* Bridge Info. Sys., Inc.), 460 F.3d 1041, 1047 (8th Cir. 2006).

[73]*See In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1033 (7th Cir. 1993). This case represents the first time a court declared that ranges instead of averages should be used. *See* Bryan Kotliar, *A New Reading of the Ordinary Course of Business Exception in Section 547(c)(2)*, AM. BANKR. INST. L. REV. 235-238 (2013).

[74]*See M. Fabrikant & Sons*, 2010 WL 4622449, at *3.

[75]*Id.* at *4.

[76]*In re* Magic Circle Energy Corp., 64 B.R. 269, 273 (Bankr. W.D. Okla. 1986).

business exception, "'should be narrowly construed.'"[77] These proponents argue that the use of averages was the intended analysis when reviewing the business relationship and transactions, as shown by the consistency in the language implying average, and since the statute should be narrowly construed, courts should not depart from the use of averages.[78]

Although copiously presented with opportunities to adopt the range approach, courts have often decided to reject the approach in favor of averages.[79] In *In re M. Fabrikant & Sons, Inc.*, one party argued in favor of adopting a range approach, stating that the test should be whether a debtor paid its invoices during the same range of time in the pre-preference period and the post-preference period.[80] This court rejected the range approach, reasoning that "aberrant, unusual payments lying well outside the average would skew (*i.e.*, expand) the range, while the average lateness computation theory would weed them out."[81] This reasoning is the most commonly cited support for the average theory.[82]

It is apparent that the average theory does not completely eliminate the effect of these aberrant payments, also known as outliers.[83] Outliers are, however, factored into the computation of the average and, when examining all the preference transactions as a whole, outliers have less of an effect under the averages model.[84] For example, if there are twelve total payments, and ten payments are made within 100 days and two payments are made within 150 days, the average payment would be around 108 days.[85] The use of range in this situation would allow payments within 150 days.[86] As shown, while not completely eliminating the effect of outliers, the average does a better job of mitigating expansion.[87]

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[77]*In re* CIS Corp., 214 B.R. 108, 119 (Bankr. S.D.N.Y. 1997) (quoting Hassett v. Altai, Inc., 195 B.R. 251, 257 (Bankr. S.D.N.Y. 1996)).

[78]*See M. Fabrikant & Sons*, 2010 WL 4622449, at *3.

[79]*See, e.g.*, *CIS Corp.*, 214 B.R. 108; *M. Fabrikant & Sons*, 2010 WL 4622449.

[80]*M. Fabrikant & Sons*, 2010 WL 4622449, at *3 n.2.

[81]*Id.* (internal quotations omitted).

[82]*See CIS Corp.*, 214 B.R. at 120-21.

[83]These unusual transactions are considered outliers because when the aberrant transactions are compared to the rest, they lie outside of the normal range. *See In re* Moltech Power Sys., Inc., 327 B.R. 675, 681 (Bankr. N.D. Fla. 2005).

[84]*See CIS Corp.*, 214 B.R. at 120-21 (stating that the average theory accounts for "irregular payments" better than the range theory).

[85]*See Moltech Power Sys.*, 327 B.R. at 680 (explaining how to calculate average).

[86]*See id.* at 681 (explaining how to calculate range).

[87]*See CIS Corp.*, 214 B.R. at 120-21.

There are two main criticisms of the average approach.[88] In the first instance, some claim that the average model is underinclusive and does not account for extrinsic factors, such as seasonal variations on performance.[89] For example, a company located in a beach town, which is subject to seasonal influences of business, may have very different payment methods during the summer, as opposed to the winter because of the effect of the season on their business.[90] Under the average approach, these two distinct periods are meshed together, leading to an inaccurate representation of the business relationship.[91] If three payments during the busy summer season were made thirty days apart, and the next three payments were made ninety days apart during the slower seasons, the average payment period comes to sixty days.[92] This shows that the average approach will not protect either the thirty day or the ninety day transactions.[93] However, under the range approach, both the ninety day payments and the thirty day payments would be protected, successfully taking into account the seasonal variation.[94]

The second critique is "that the unusual weight of individual figures can lead to erroneous averages."[95] This means that severe outliers combined with a small sample size will skew the average greatly.[96] Unlike the range approach used by the Third Circuit, which considers the length of the relationship between a debtor and creditor, the average approach makes no such inquiry.[97] For example, if there is only a history of five payments, and three were made within 30 days, and two were made within 120 days, the average comes out to 66.[98] This is not an accurate representation of either the payments made within 30 days, or the payments made within 120 days.[99] Another way that individual figures can skew the average is if there were two payments made within

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[88]Speco Corp. v. Canton Drop Forge (*In re* Speco Corp.), 218 B.R. 390, 399 (Bankr. S.D. Ohio 1998).

[89]*Id.*

[90]*See id.*

[91]*See id.*

[92]*See In re* Moltech Power Sys., Inc., 327 B.R. 675, 680 (Bankr. N.D. Fla. 2005).

[93]*See Speco Corp.*, 218 B.R. at 399.

[94]*See id.*

[95]*Id.*

[96]*See id.*

[97]*See infra* Part III.D (explaining that the Third Circuit has endorsed the range approach).

[98]*See In re* Moltech Power Sys., Inc, 327 B.R. 675, 680 (Bankr. N.D. Fla. 2005) (explaining how to calculate average).

[99]*See Speco Corp.*, 218 B.R. at 399.

30 days, two made within 60 days, and two made within 90 days, the average comes out to 60.[100] This would render the 30 and 90 day payments to be unusual.[101]

Overall, the average approach is well equipped to handle aberrant transactions, as long as there is a sufficient sample size to mitigate their effect.[102] However, the inability to account for extrinsic factors can make this test both underinclusive and constraining on businesses.[103]

D. *The Range Approach*

Currently, the range approach has been endorsed by courts in the Third,[104] Fourth,[105] Seventh,[106] Ninth,[107] and Tenth[108] Circuits. Again, the range approach compares the range of pre-preference transactions to the range of transactions made during the preference period.[109] The Seventh Circuit was the first to endorse the use of a range approach in *In re Tolona Pizza Prods. Corp.*[110] In an opinion authored by Judge Posner, the court concluded that "only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of [547(c)(2)(b)]."[111] The reasoning for the adoption of range is best encompassed in an often quoted passage in the majority's decision: "The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both

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[100] *See Moltech Power Sys.*, 327 B.R. at 680 (explaining how to calculate average).

[101] *See Speco Corp.*, 218 B.R. at 399.

[102] M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at *3 n.2 (Bankr. S.D.N.Y. Nov. 4, 2010).

[103] *See Speco Corp.*, 218 B.R. at 399.

[104] *See In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 220 (3d Cir. 1994).

[105] Gordon v. Siems Rental & Sales Co. (*In re* M.P. Indus., Inc.), 2000 WL 766093, at *6 (4th Cir. June 7, 2000).

[106] *In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032 (7th Cir. 1993).

[107] Ganis Credit Corp. v. Anderson, 315 F.3d 1192, 1198 (9th Cir. 2003).

[108] Gonzales v. DPI Food Prods. Co. (*In re* Furrs Supermarkets, Inc.), 296 B.R. 33, 44-45 (Bankr. D.N.M. 2003).

[109] *In re* Moltech Power Sys., Inc., 327 B.R. 675, 681 (Bankr. N.D. Fla. 2005).

[110] *See Tolona Pizza Corp.*, 3 F.3d at 1033.

[111] *Id.* The language of this quote clearly shows that the range approach is intended to broaden the scope of acceptable transactions, thus giving more deference to the relationship between a debtor and the creditor. This is in line with the 2005 amendments to the Code, which also provided more deference to the relationship between a debtor and creditor by requiring only one prong to be satisfied. *See supra* Part III.A.

the buying and the selling side of the market."[112]

The *Tolona Pizza* court took the first step toward providing more freedom to businesses in the OCB defense by focusing its analysis "not [on] the dealings between the debtor and the allegedly favored creditor [to] conform to some industry norm but [to] conform to the norm established by the debtor and the creditor in the period before, preferably well before, the preference period."[113] By focusing more on the individual relationship, struggling businesses have a better ability to continue their normal business operations without being forced to conform to an arbitrary industry norm.[114]

It is important to note that there are two variations of the range analysis, the *Tolona Pizza* standard announced by the Seventh Circuit (stated above), and the embellishment made to that same decision by the Third Circuit.[115] In *In re Molded Acoustical Products*, the Third Circuit stated:

> We believe that the Court of Appeals for the Seventh Circuit delivered the best rendering of the text of § 547(c)(2)(C) when it held that "'ordinary business terms' refers to 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 dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C." We will embellish the Seventh Circuit test, however, with a rule that subsection C countenances a greater departure from that range of terms the longer the pre-*insolvency* relationship between a debtor and creditor was solidified.[116]

The court in *Molded Acoustical Products* called *Tolona Pizza* to the attention of both parties.[117] Interestingly, both parties advocated for the adoption of the range standard, showing that they both believed they would prevail under the range analysis.[118] The court took this as a

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[112]*Tolona Pizza Corp.*, 3 F.3d at 1033.
[113]*Id.* at 1032.
[114]*See id.*
[115]*See In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 220 (3d Cir. 1994).
[116]*Id.*
[117]*Id*. at 224 n.9.
[118]*Id.*

showing that further refinement was necessary, and accordingly added onto the *Tolona Pizza* requirements.[119] The *Molded Acoustical Products* court stated that "the more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain within the safe harbor of § 547(c)(2)."[120]

The embellishment by the Third Circuit merely elevated *dicta* from the *Tolona Pizza* decision into a rule of law, but emphasized that the length of the relationship between the creditor and debtor must be considered when using the range, and this "effectuates the major policies underlying the preference provisions."[121] In adopting the Third Circuit approach, the Fourth Circuit agreed that the length of the relationship between creditor and debtor should be considered, stating "where the debtor and creditor have only recently begun their relationship, the industry norm becomes critical because there is no baseline against which to compare the pre-petition transfers at issue to confirm that the parties would have reached the same terms absent the looming bankruptcy."[122] Conversely, "when the parties have an established relationship, the terms previously used by the parties in their course of

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[119] *Molded Acoustical Prods.*, 18 F.3d at 224 n.9.

[120] *Id.* at 225. Further, the court reasoned that "[t]he likelihood of unfair overreaching by a creditor (to the disadvantage of other creditors) is reduced if the parties sustained the same relationship for a substantial time frame prior to the debtor's insolvency." *Id.* The Third Circuit also stated that the emphasis on the existing relationship is also consistent with the policy underlying the Code:

> [W]hen the relationship in question has been cemented long before the onset of insolvency—up through and including the preference period—we should pause and consider carefully before further impairing a creditor whose confident, consistent, ordinary extension of trade credit has given the straitened debtor a fighting chance of sidestepping bankruptcy and continuing in business. Bankruptcy policy, as evidenced by the very existence of § 547(c)(2), is to promote such continuing relationships on level terms, relationships which if encouraged will often help businesses fend off an unwelcome voyage into the labyrinths of a bankruptcy. On the other hand, where the relationship is of recent origin, a significant departure from credit terms normal to the trade bears the earmarks of favoritism and/or exploitation, and to countenance such behavior could be unfair (or could appear unfair) to the remaining creditors who exhibit the virtue of patience.

Id. at 224-25 (citations omitted).

[121] *In re* M.P. Indus., Inc., 2000 WL 766093, at *4 (4th Cir. June 7, 2000).

[122] *Id.* at *4 (alteration in original) (citations omitted) (internal quotations omitted). The reasoning behind the refusal to allow the relationship between a debtor and a creditor to be dispositive is to ensure that their practices do not depart so far from the industry norm as to constitute unfair practices. *Id.*

dealings are available as a potential baseline."[123] Thus, "[t]he industry norm, though still relevant, becomes less significant."[124] However, courts have been reluctant to state that the length of a relationship can be dispositive of their business dealings.[125]

Looking at the parties' course of dealings, as opposed to the industry standard, also mitigates the problem of identifying which industry standard applies to long-term relationships.[126] While consideration of the industry standard is still very important for relationships that do not have a solid baseline of transactions for comparison, in relationships that have been ongoing for some time, the industry standard, while relevant, becomes less influential.[127] Thus, the embellishment to the range approach more fully addresses the issues identified by the Seventh Circuit in *Tolona Pizza*: giving freedom to businesses and assisting a debtor during their slide towards bankruptcy.[128]

The Third Circuit's embellishment was also the first attempt to mitigate the influence of outliers.[129] If a debtor/creditor's relationship is in its infancy, there will be a very small sample size, and outliers will not be easily explained.[130] Thus, the use of the industry standard becomes increasingly important.[131] On the other hand, if a debtor and creditor have an established relationship, more data is available, and the industry norm becomes less influential.[132] However, courts are not given any statutory guidance as to how much emphasis should be placed on the industry standard based upon the history of the parties transactions.[133] Furthermore, while the embellishment attempts to validate potential aberrant transactions in certain circumstances, it does nothing to

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[123] *Id.*

[124] *M.P. Indus., Inc.*, 2000 WL 766093, at *4. Note that this case was decided prior to the 2005 amendments to the Code, so both prongs had to be satisfied.

[125] *See In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 224 n.9 (3d Cir. 1994). The court explained that the industry standard must always be considered in order to ensure that the personal business deviations are not so far removed from normal as to constitute unfair practices. *See id.* at 224.

[126] *See id.*

[127] *M.P. Indus., Inc.*, 2000 WL 766093, at *4.

[128] *See In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032 (7th Cir. 1993).

[129] *See M.P. Indus., Inc.*, 2000 WL 766093, at *3-*4.

[130] *See id.* at *4.

[131] *Id.*

[132] *Id.*

[133] *See, e.g.*, *In re* Molded Acoustical Prods. Inc., 18 F.3d 217, 223 (3d Cir. 1994) (recognizing that the court has been left with "a relatively clean slate," without any guidelines as to how the industry standard should be weighed and applied).

eliminate the effect that these transactions have.[134]

The main critique of the range approach is that aberrant transactions, or outliers, will skew or enlarge the range, so that it does not accurately depict the business dealings and allows too many transactions to be considered normal.[135] For example, if payments were made within 30 days once, 90 days ten times, and 180 days once, the range would allow for payments between 30 days and 180 days, whereas the average would come to 92.5 days. This simple example shows how the average deals with outliers better than the range.

Overall, the range approach gives more freedom to businesses during their slide into bankruptcy, thus giving debtors a better chance to recover and emerge from debt.[136] However, the range approach is very susceptible to the influence of aberrant transactions, and can be considered overly inclusive.[137]

IV. EVALUATION

As shown above, both the average approach and the range approach have their respective strengths and weaknesses.[138] The average approach does not account for seasonal variations and other extrinsic factors, and therefore can be underinclusive and constraining.[139] In response to the constraining and underinclusive nature of the average approach, the Seventh Circuit adopted the range approach.[140] However, the range approach is susceptible to being heavily influenced by aberrant transactions, and therefore can be overinclusive.[141] In *Molded Acoustical Products* the Third Circuit made the first attempt at resolving this by modifying the test set forth in *Tolona Pizza* by adding that the length of the pre-preference relationship between a debtor and creditors should also be considered.[142]

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[134] *In re* CIS Corp., 214 B.R. 108, 120-21 (Bankr. S.D.N.Y. 1997). This is because the outliers are still computed in the range. For a discussion on how to eliminate the outliers, see *infra* Part IV.A.1.

[135] *CIS Corp.*, 214 B.R. at 120-21.

[136] *See Tolona Pizza Corp.*, 3 F.3d at 1033.

[137] M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at *8 n.2 (Bankr. S.D.N.Y. Nov. 4, 2010).

[138] *See supra* Part III.C-D.

[139] *See supra* Part III.C.

[140] *See supra* Part III.D.

[141] *See supra* Part III.D.

[142] *See In re* M.P. Indus., Inc., 2000 WL 766093, at *3-*4 (4th Cir. June 7, 2000).

A. *Remedying the Criticisms*

1. Aberrant Transactions Skewing Data: Trimming

Although the main critique of the range approach is its susceptibility to outliers, both the average approach and the range approach are influenced by outliers.[143] Even though the average approach better mitigates the effects of outliers, both approaches would benefit if outliers could be eliminated from consideration. This Author's approach to dealing with outliers requires a two-step analysis. First, a simple, common methodology of identifying outliers, specifically focusing on determining if they are present in the data, will be used.[144] The second step involves a statistical method to eliminate the effects of the outlier.

There are numerous ways to achieve statistical certainty on the matter of identifying the existence of outliers through the use of intricate tests.[145] Despite an abundance of convoluted tests that can be used to achieve statistical certainty, this Author believes a simple method is more beneficial for three reasons. First, a simple test allows debtors and creditors to determine for themselves, before a declaration of bankruptcy, if they are acting in accordance with the law. If the parties involved have a simple standard they can apply themselves, the parties can preemptively act to ensure that their relationship and transactions will be protected. This will result in fewer filings of preference actions, and, in the same vein, more settlements of preference claims. The second reason is to avoid the "battle of the experts," which can be expensive and time-

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[143]M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at *8 n.2 (Bankr. S.D.N.Y. Nov. 4, 2010).

[144]It is important to first identify the existence of outliers to determine if a trimmed mean or range should be utilized. It can be assumed that under this approach, the existence of outliers will be a contested issue. The use of a trimmed mean or trimmed range in identifying the outlier provides a simple and efficient identification method, which will give the parties the best opportunity to resolve the issue.

[145]For example, the *Reference Manual on Scientific Evidence*, which is used by judges when confronted with statistical evidence, advocates for the use of hypothesis testing or the use of correlation and regression models. However, these are complex statistical methods, requiring expert testimony. *See generally* DAVID H. KAYE & DAVID A. FREEDMAN, REFERENCE MANUAL ON SCIENTIFIC EVIDENCE, REFERENCE GUIDE ON STATISTICS 85-177 (2000), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/sciman00.pdf/$file/sciman00.pdf. As will be explained below, precise statistical tests requiring expert testimony are not the best remedy.

consuming.[146] Further, there are many different ways to analyze data and experts may do more harm than good by utilizing complex methods of analysis.[147] Finally, and most importantly, statistical certainty is not an ideal outcome, because there should be some leeway to consider the relationship between debtors and creditors, along with providing enough room for the courts to apply the standard. Every business operates differently, and if the statistics were too precise then debtors, creditors, and courts would be constrained by their application.[148]

A simple way to identify both the existence and effect of outliers is through the use of trimmed means and trimmed ranges.[149] Trimming is a statistical method used to eliminate a pre-specified percentage of the highest and lowest data points, and the average or range is calculated without this data.[150] This Author proposes that the trimmed calculation should only be applied to the pre-preference transactions.[151] This trimmed calculation is then compared to the original calculation to demonstrate both the existence and impact of the outliers.[152]

It is also important to select an appropriate percentage by which the data set will be trimmed.[153] It is this Author's position that 5 percent is a satisfactory starting point. A 5 percent trim eliminates only the most egregious transactions.[154] More importantly, a small trim will not eliminate so many outliers so as to change the relationship of the parties.[155] If too many transactions are eliminated, the trimmed result will not be an accurate representation of the relationship.[156] However,

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[146]*See Expert Witnesses: Worth the Time and Money?*, PELLEGRINO & ASSOCS. (2013), http://www.pellegrinoandassociates.com/expert-witnesses-worth-the-time-and-money/.

[147]*See* KAYE & FREEDMAN, *supra* note 145, at 90.

[148]*See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

[149]*See* Dr. Scott Preston, *Trimmed Means*, STATE UNIV. OF N.Y.C. OSWEGO, http://www.oswego.edu/~srp/ stats/tr_mean.htm (last visited Mar. 26, 2013); KAYE & FREEDMAN, *supra* note 145, at 115.

[150]Preston, *supra* note 149.

[151]Because of the limited amount of payments available during the ninety day preference period, trimming should not be used for these transactions. Trimming a very small sample size could overly distort a short relationship. *See* SHARI SEIDMAN DIAMOND, REFERENCE MANUAL ON SCIENTIFIC EVIDENCE, REFERENCE GUIDE ON SURVEY RESEARCH, FED. JUDICIAL CTR., 242 (2000), *available at* http://www.fjc.gov/public/pdf.nsf/ lookup/sciman00.pdf/$file/sciman00.pdf.

[152]*See* Preston, *supra* note 149.

[153]*Id.*

[154]*Id.*

[155]*Id.*

[156]One critique of trimming is that it changes the relationship of the data. *See id*. However, this is exactly what is necessary when dealing with outliers in the OCB defense.

this should not be a hard rule, and courts should be given deference to adjust the trim based on the relationship between the parties. If there is a long history between the parties, following the reasoning in *Molded Acoustical Products*, more deference should be given to their relationship.[157] Accordingly, if a court finds that the parties have a long relationship, it is appropriate to lower the trim percentage in order to allow for more transactions to be considered, thus placing more weight on the existing relationship.

For example, say pre-preference payments were made within 10 days once, within 30 days nine times, within 60 days nine times, and within 180 days once, for a total of twenty payments. The untrimmed range would be between 10 and 180 days, and the untrimmed average would be 50 days. However, using a 5 percent trim on both ends (for twenty payments this would eliminate the largest and smallest data point), the range comes to between 30 and 60 days, and the average comes to 45. This example presents a much more accurate representation of the relationship.

If the untrimmed results are compared to the trimmed results, outliers ostensibly skew the data. The skew is shown by the difference in the outcomes. Because the average approach inherently eliminates the effects of outliers better than the range approach, the difference will be less pronounced than it would be using the range. If the trimmed results are not considerably different than the untrimmed results, then outliers are not skewing the data.[158]

When the OCB defense is raised, either party may declare that outliers are skewing the data.[159] The challenging party then presents the trimmed results, comparing them to the untrimmed results in order to show that outliers are considerably skewing the relationship of the parties. If the reviewing court concludes that outliers are considerably skewing the relationship, the trimmed results will be used. If the court concludes that outliers are not considerably skewing the relationship, the untrimmed results will be used.

This method is extremely effective when coupled with the Third

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The outliers themselves are not accurate representations of the relationship; therefore, the relationship is more accurately described by eliminating aberrant data. *See* Preston, *supra* note 149.

[157] *In re* Molded Acoustical Prods., 18 F.3d 217, 224-25 (3d Cir. 1994).

[158] It is important to note that trimming does not have to eliminate every outlier. If a trim is completed, and certain unusual transactions still remain, this could show that the transactions were not as unusual as originally expected.

[159] *See Molded Acoustical Prods.*, 18 F.3d at 222.

Circuit's embellished range approach.[160] The Third Circuit's approach directly mitigates the effect of the industry standard conundrum, while inadvertently addressing the unusual transaction problem.[161] With the addition of the trimmed range approach, this new test directly addresses both issues, while also furthering the policies underlying the code and preference actions—fairness and equality.

2. Underinclusiveness of the Average Approach

One of the main critiques of the average approach is that it is underinclusive and does not account for extrinsic factors such as seasonal variations.[162] This leads to results that are not true representations of the relationship between a debtor and the creditor.[163] While it is impossible to list all of the situations for which the underinclusiveness of the average approach does not account, one commonly cited situation is seasonal variations.[164] To remedy this, courts may be wise to consider allowing the parties to break down the calculations in a manner that facilitates the showing of these effects, and then compare the broken down calculations to the original calculation.

Using seasonal variations as an example, courts could allow parties to present the averages of payments by season. This would show the seasonal variations present in the relationship between the parties. The court could then compare this analysis to the original analysis to see if they are substantially different. The goal of the comparison would be to determine if a seasonal variation exists, and then to determine if the payments were made in accordance to the seasonal variation. If the reviewing court finds that a seasonal variation exists, and the payments were made in accordance with this variation, the transaction should not be clawed back.

However, this approach is easily susceptible to abuse. Lawyers are clever, and will be able to find many ways to present data in a way that would show influence of extrinsic factors. Furthermore, this approach may only be applicable in the context of seasonal variations. To control this, courts would have to impose many limitations and special rules, which may make application overly difficult. In short,

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[160] *Id.* at 220, 225.
[161] *Id.*
[162] *See supra* Part III.C.
[163] *See supra* Part III.C.
[164] *See supra* Part III.C.

there is no proven way to remedy the underinclusiveness of the average approach.

B. *The Best Approach*

Neither approach is perfect. This Author, however, submits that the range approach, as modified by the Third Circuit in *Molded Acoustical Products*, best encompasses the Code's policies and goals.

First, the range approach gives businesses on the verge of insolvency more leeway in running their business.[165] This approach allows debtors to function more normally during their lapse into bankruptcy than they would be able to under the average approach.[166] If debtors are able to continue running their business unimpeded by the threat of bankruptcy, creditors will be more willing to continue the relationship because they know their payments will not be clawed back.[167] One of the most important policy considerations underlying preference actions is to allow both debtors and creditors to continue their relationships undisturbed.[168] By giving debtors more latitude in their relationships with creditors, more relationships will be left undisturbed, thus achieving one of the Code's goals.[169]

Second, the embellishment in *Molded Acoustical Products* considers the length of the relationship between a debtor and creditor.[170] Consideration of the length of the relationship provides greater deference to long-standing business relationships, while ensuring fair practices.[171] This consideration also more fully achieves the purposes and policies underlying the Code; namely, facilitating the potential re-emergence of a bankrupt debtor by enabling the business to continue operating as if it were not insolvent.[172] Additionally, this embellishment carefully balances the amount of emphasis that should be placed on the industry standard.[173] As stated above, defining the industry standard can be

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[165] *See In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032 (7th Cir. 1993).
[166] *See id.*
[167] *See id.*
[168] *See supra* Part II.
[169] *See In re* Tolona Pizza Prods. Corp., 3 F.3d at 1032*; In re* Molded Acoustical Prods., 18 F.3d 217, 219, 225 (3d Cir. 1994).
[170] *Molded Acoustical Prods.*, 18 F.3d at 224-25.
[171] *Id.* at 225.
[172] *Id.*
[173] *See id.* at 224.

difficult.[174] Under the embellishment to the range approach and the model proposed in this Note, longer business relationships result in less emphasis on the industry standard, thus allowing business to continue undisturbed.[175] However, the industry standard is still very useful for shorter relationships that do not have a good baseline of dealing, and this test correctly utilizes the industry standard in these situations.[176]

Third, the range approach takes into account seasonal variations and other extrinsic factors that the average approach cannot.[177] Countless industries are affected by seasonal variations, making this an important critique against the average approach.[178] With so many industries affected by seasonal variations, it is imperative to have a test that has the flexibility to account for these types of extrinsic factors. While the underinclusiveness of the average approach precludes this ability, the range approach is not so constrained.[179]

Fourth, although never explicitly stated by any binding authority, the range approach is more in line with the 2005 amendments to the Code. Recall that the amendments are considered to be creditor friendly because, under the amendments, only one of the prongs of the OCB defense must be satisfied, giving creditors greater latitude in their dealings with the debtor.[180] As stated in *Tolona Pizza*, the reasoning for adopting the range approach was a response to the overly-constraining results produced by the average approach.[181] Thus, both the range approach and the 2005 amendments give creditors more freedom, and show a trend of leniency towards creditors in both preference actions and the OCB defense.[182]

Finally, the major critique of the range approach is its susceptibility to influence from aberrant transactions—but this can be remedied.[183] As shown above, using a trimmed range can show the presence of outliers, and it can also remedy the effect of outliers by

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[174] *Molded Acoustical Prods.*, 18 F.3d at 224.

[175] *See id.*

[176] *See id.* at 225.

[177] *See supra* Part III.C.

[178] *See Seasonal Businesses Law and Legal Definition*, US LEGAL, http://definitions.uslegal.com/s/seasonal-businesses/, (last visited June 19, 2013).

[179] *In re* Speco Corp., 218 B.R. 390, 399 (Bankr. S.D. Ohio 1998).

[180] *See* Taylor & Henderson, *supra* note 18, at 62.

[181] *See In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1033 (7th Cir. 1993).

[182] *See In re* Molded Acoustical Prods., 18 F.3d 217, 219, 224 (3d Cir. 1994); Taylor & Henderson, *supra* note 18, at 62.

[183] *See supra* Part IV.A.1.

removing them if appropriate.[184] Unlike the criticisms of the average approach, which are difficult to remedy,[185] the criticisms of the range approach can be alleviated. Without the criticism that outliers too heavily influence the range approach, critics no longer have ground to stand on. New critiques and other methods to identify and deal with outliers will undoubtedly arise; however, the fact of matter is that the range approach, as narrowed by some sort of statistical methodology, is the better approach.

V. CONCLUSION

Overall, the range approach has taken the first steps towards addressing the uncertainty surrounding the OCB defense. First adopted by the Seventh Circuit in 1993,[186] the range approach was embellished by the Third Circuit a year later.[187] Since then, three other circuits have adopted the range approach.[188] However, this approach has remained stagnant in recent years after the Third Circuit's embellishment, and courts have been reluctant to add additional clarifications.[189] Nevertheless, as shown by *American Home Mortgage Holdings, Inc.*, a case within the Third Circuit, the waters are still muddy, and further refinement is necessary for clarification of the analysis.[190] Additionally, many courts have been reluctant to adopt the range approach because of the impact unusual transactions have by skewing the range.[191]

The addition of a trimmed range analysis to the Third Circuit's range embellishment would resolve the remaining ambiguities and has

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[184] *Id.*

[185] *See, e.g., In re* Speco Corp., 218 B.R. 390, 399 (Bankr. S.D. Ohio 1998) ("Averages alone fail to take into account extraneous factors such as seasonal influences on performance in certain industries, or the fact that the unusual weight of individual figures can lead to erroneous averages.") (internal citations omitted).

[186] *In re* Tolona Pizza Prods. Corp., 3 F.3d at 1033.

[187] *Molded Acoustical Corp.*, 18 F.3d at 224-25.

[188] *See supra* Part III.D.

[189] *See* Ganis Credit Corp. v. Anderson, 315 F.3d 1192, 1198 (9th Cir. 2003); *In re* M.P. Indus., Inc., 2000 WL 766093, at *4 (4th Cir. June 7, 2000).

[190] *See In re* Am. Home Mortg. Holdings, Inc., 476 B.R. 124, 141 (Bankr. D. Del. 2012).

[191] *See* M. Fabrikant & Sons, Inc. v. Gramercy Jewelry Mfg. Corp., 2010 WL 4622449, at *8 n.2 (Bankr. S.D.N.Y. Nov. 4, 2010); *In re* CIS Corp., Inc., 214 B.R. 108, 120-21 (Bankr. S.D.N.Y. 1997).

the ability to unify the circuits by diminishing the effect of outliers.[192] The trimmed range analysis, as articulated in this Note, provides judges, attorneys, businesses, and creditors with a clear and simple standard that can be easily applied, thus mollifying the concerns and apprehensions attorneys have in this area. In so assuaging, adoption of this approach will undeniably result in more settlements and more predictable court decisions. Further, by providing a simple method that identifies outliers and provides a remedy to diminish their undesired effects, more circuits will be willing to adopt this approach, creating a unified national standard. The law is in a constant state of evolution, striving for fairness and clarity. In order for the OCB defense to survive, it must also continue to evolve and not remain stagnant as it has since the 2005 amendments. Adopting the trimmed range approach to embellish the current approach in the Third Circuit would be a step forward in the evolution of bankruptcy law, preference actions, and most notably, the OCB defense.

Joseph M. Mulvihill

[192] *See supra* Part IV.A.1.