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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

FILED

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NORTHERN DISTRICT OF OHIO
CLEVELAND

In re:) Case No. 94-12622
)
WIT & WISDOM CORPORATION,) Chapter 11
)
Debtor.) Judge Pat E. Morgenstern-Clarren
)
) **MEMORANDUM OF OPINION**

This matter is before the Court on the Objection of Society National Bank ("Bank") to the Allowance of the Claim of Partners Book Distributing, Inc. ("Partners"). The parties submitted the matter for determination on stipulated facts. (Docket 184). Following the filing of the Joint Stipulation and briefs, the Court held a hearing at which time the parties were advised of the decision the Court anticipated entering and were asked to provide additional facts needed in order to enter judgment on the Objection. (Docket 254). The parties responded with a Joint Supplemental Stipulation of Facts. (Docket 258). After review of those additional facts, both separately and in the overall context of the initial Joint Stipulation, the Court has concluded that the appropriate decision in this matter is other than that anticipated at the time of the hearing. And so, for the reasons set forth below, Bank's Objection is overruled.

JURISDICTION

The Court has jurisdiction to hear this matter under 28 U.S.C. § 1334 and General Order No. 84 entered on July 16, 1984 by the United States District Court for the Northern District of Ohio. This is a core proceeding under 28 U.S.C. §§ 157(b)(2)(B), (D), (O).

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FACTS

The relevant facts are set forth in the Joint Stipulation of Facts and the Supplemental Stipulation:

1. Wit and Wisdom Corporation ("Debtor") filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code on June 22, 1994.
2. Partners extended trade credit to Debtor pre-petition, with \$131,000 being the highest level that Debtor's pre-petition payable balance to Partners reached.
3. Pre-petition, Debtor's open credit line with Partners was \$150,000, invoices were payable on net 60 day terms, and they were actually paid between 60 and 75 days. Post-petition, Partners' invoices to Debtor continued to be payable on net 60 day terms until April 1995.
4. Pre-petition, Debtor regularly purchased inventory on credit from multiple vendors, including Partners. Post-petition, Debtor's inventory purchases from Partners increased while its purchases from other vendors remained at or below pre-petition levels.
5. Post-petition, Debtor provided to Bank from time to time records of Debtor's accounts payable; these records included information as to the amount of Debtor's post-petition accounts payable to Partners.
6. Debtor's levels of post-petition inventory purchases from all sources did not, in the aggregate, substantially exceed the aggregate of its pre-petition levels of inventory purchases.
7. Between June 1994 and March 1995, Debtor's payable to Partners at each calendar month end was as reflected on the chart attached to the Joint Stipulation as Exhibit A.
8. On April 1, 1995, Debtor executed a \$150,000 promissory note payable to Partners (including amendments, the "Note") which consolidated and termed out certain

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obligations of Debtor to Partners for inventory purchases, as reflected on invoices issued by Partners between December 6, 1994 and January 11, 1995.

9. In connection with the Note, and at approximately the same time as the Note was signed, Debtor paid \$121,000 to Partners on past due post-petition invoices.

10. As a result of Debtor's execution of the Note and the \$121,000 payment, Partners agreed to extend a \$200,000 open credit line to Debtor, with invoices payable on net 75 day terms. The parties memorialized this agreement in a letter from Partners to Debtor dated April 10, 1995.

11. The \$200,000 credit line would not have been available to Debtor, and Partners would not have extended additional trade credit in excess of the \$430,000 due at month end March 1995, but for Debtor's execution of the Note and payment of the \$121,000.

12. On June 15, 1995, the Note was replaced with a new Note.

13. Other than on April 1, 1995 and June 15, 1995, Debtor has never converted all or any portion of an account payable owed to Partners to a promissory note.

14. The \$150,000 balance of the Note has been reduced by \$17,779.75 since April 1, 1995.

15. The various Cash Collateral Orders entered in this case and the terms of Debtor's post-confirmation obligations to Bank all permit Debtor to expend funds for the purchase of inventory.

16. All of the inventory purchased from Partners by Debtor, as well as the proceeds of it, became subject to the security interest of Bank, and Bank continues to retain a security interest in the inventory of Debtor and the proceeds.

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17. But for the willingness of Partners to sell inventory on credit to Debtor or the availability of third party credit or financing, Debtor would not have had the ability to maintain its post-petition business operations and confirm its Chapter 11 plan.

18. Partners has not filed a request for payment of administrative expense. However, the Supplemental Stipulation filed by the parties quantifies Partners' claim as follows:

- a. During the period April 1, 1995 through December 6, 1995, Debtor purchased goods on account from Partners having an aggregate invoice price of \$561,806.62.
- b. During the period April 1, 1995 through December 6, 1995, Debtor made payments on account to Partners in the aggregate amount of \$341,108.94 and returned goods having an aggregate invoice price of \$203,271.34 to Partners for credit.
- c. Of the total payments and returns set forth in paragraph b, above, the aggregate amount of \$175,756.97 was applied to invoices issued by Partners to Debtor prior to April 1, 1995.
- d. As of December 6, 1995, the unpaid balance due to Partners from Debtor on invoices issued during the period April 1, 1995 through December 6, 1995 was \$193,183.31.

The Stipulations fail to quantify Partner's request for payment with respect to goods purchased prior to April 1, 1995.

ISSUE

Did Debtor incur the Partners' debt "in the ordinary course" of Debtor's business, as that phrase is used in 11 U.S.C. § 364?

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DISCUSSION

I.

Bank argues that most of the claim was not incurred in the ordinary course because the amount of the credit increased significantly post-petition and the payment terms changed as well. From these facts, Bank concludes that Debtor should have obtained bankruptcy court approval before incurring the debt and that, absent such approval, Partners' claim should be disallowed or relegated to a non-priority status. Bank does not identify a specific point in time at which the transactions are believed to fall outside of the ordinary course, asking instead that the Court find that the transformation took place at some point between August 31, 1994 and April 1, 1995. (Bank's Memorandum at 5) (Docket 189).

Partners contends its claim was incurred in the ordinary course of Debtor's business, did not require prior court approval, and is, therefore, entitled to be paid in full as an administrative priority claim. Alternatively, Partners requests retroactive approval of the transactions, a request which Society opposes on the ground that equity cannot be used to remedy a party's failure to comply with a specific Code provision.

II. Section 364(a)

Section 364(a) of the Bankruptcy Code is the starting point for determining Debtor's ability to incur this debt without prior court approval. The statute provides that:

- (a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1304, 1203, or 1204 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

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11 U.S.C. § 364(a) (amended 1994).¹ If the transaction is outside of the ordinary course, the debt may still be treated as an administrative expense provided that the bankruptcy court approves the transaction, after notice and a hearing. 11 U.S.C. § 364(b). Unsecured debt that is obtained outside of the ordinary course and without bankruptcy court approval is not entitled to be paid as an administrative claim.

While the phrase “ordinary course of business” appears in various Bankruptcy Code sections, it is not defined in the Code. The courts have developed two tests to define this term: the vertical dimension test, also referred to as the creditors’ expectation test, and the horizontal dimension test. See *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988). The vertical dimension test views the disputed transaction from “. . . the vantage point of a hypothetical creditor and inquires whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit.” *In re Johns-Manville Corp.*, 60 B.R. 612, 616 (Bankr. S.D. N.Y. 1986). The horizontal dimension test focuses on the nature of the debtor’s business and inquires “whether the postpetition transaction is of a type that other similar businesses would engage in as ordinary business.” *In re Dant & Russell, Inc.* at 704. Courts frequently apply both tests in determining whether a transaction is in the ordinary course of a debtor’s business. *Dant & Russell* (applying vertical and horizontal tests to determine that execution of a post-petition

¹ A debtor in possession has all of the rights, functions and duties of a trustee under 11 U.S.C. § 1107(a).

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lease fell within the meaning of “ordinary course of business” under § 363(c); *In re Poff Construction, Inc.*, 141 B.R. 104 (D.Ct. W.D. Va. 1991) (both tests deemed applicable to a determination regarding ordinary course under § 364(a)).

Recently, the court in *In re Garofalo’s Finer Foods, Inc.*, 186 B.R. 414 (D.Ct. N.D. Ill. 1995) dealt with a transaction under § 364(a) and discussed the appropriate test for ordinary course determinations under that section. *Garofalo* held that determinations regarding the ordinary course of a debtor’s business should focus solely on the reasonable expectations test. In reaching this conclusion, the court compared the language of the preference statute, 11 U.S.C. § 547, to that of § 364. While both refer to the “ordinary course of business,” only § 547 goes on to require that the transfer at issue also be made “according to ordinary business terms.” In the absence of such a requirement in § 364, the court found that the horizontal dimension test was unnecessary and objective analysis of an industry’s practice and custom was not required:

As demonstrated by the text and structure of section 547(c)(2), Congress could have required that post-petition credit be obtained within the ordinary course of business *and* according to ordinary business terms; however, it chose not to do so. The objective analysis of an industry’s practice and custom required under section 547(c)(2) is thus not required to determine whether credit was extended within the ordinary course of business under section 364(a).

Garofalo at 429 (emphasis added). The reasoning of the *Garofalo* case is sound and is adopted by this Court.²

² The Court notes that (1) the parties have assumed in their briefs that only the vertical dimension test applies; and (2) the Stipulations do not contain any factual basis for making a determination under the horizontal dimension test. The parties are, therefore, in agreement as to the legal standard to be applied.

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III. Vertical Dimension Test

A creditor's reasonable expectations of a debtor's 'ordinary course of business' are based in large part upon the debtor's specific pre-petition business practices and norms and the expectation that the debtor will conform to those practices and norms while operating as a debtor-in-possession. Thus, a fundamental characteristic of an 'ordinary' post-petition business transaction is its similarity to a pre-petition business practice.

Garofalo at 425.

The touchstone of 'ordinariness' is thus the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business. So long as the transactions conducted are consistent with these expectations, creditors have no right to notice and hearing, because their objections to such transactions are likely to relate to the bankrupt's chapter 11 status, not the particular transactions themselves.

In re James A. Phillips, Inc., 29 B.R. 391, 394 (D.Ct. S.D.N.Y. 1983). Pre-petition activity, however, only provides a starting point for this determination. A debtor's changing circumstances as it attempts to operate its business under Chapter 11 must also be considered. *In re Roth American, Inc.*; *In re Garofalo's Finer Foods, Inc.*; *In re Johns-Manville Corp.* "A rigid similarity is, therefore, not required; rather, the post-petition transaction must have some consistency with a pre-petition transaction." *Garofalo* at 426. The size, nature and type of the transaction and of the debtor's business are all relevant to the determination of ordinariness. *In re Johns-Manville Corp.* Additionally, a transaction can be in the ordinary course of a debtor's financial affairs even when it is the first such transaction undertaken. *In re Finn*, 909 F.2d 903 (6th Cir. 1990) (considering "ordinary course" exception to preference recovery under § 547(c)(2)).

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Looking first to the type of transactions at issue in this case, it is undisputed that they are the same both pre- and post-petition. Prior to the Chapter 11 filing, Debtor purchased inventory on credit from Partners and other suppliers. The purchase of inventory on credit continued post-petition, with those expenditures provided for under the various cash collateral orders. While the purchase of inventory from Partners increased post-petition, purchases from other suppliers declined so that the post-petition purchases did not in the aggregate substantially exceed pre-petition levels of inventory purchases. Bank was fully aware from information provided to it by Debtor that the amount of the post-petition receivable had increased; there were no surprises or hidden transactions. In general, therefore, the purchase of inventory from Partners on credit post-petition was in the ordinary course of Debtor's business and would not conflict with the reasonable expectations of creditors, bearing in mind that the Code does not require a static similarity between pre- and post-petition transactions.

Bank contends, however, that at some point between August 31, 1994 and April 1, 1995 the size and nature of the transactions between Debtor and Partners became so dissimilar to the pre-petition dealings as to render them outside the ordinary course of Debtor's business. Bank's argument that this change took place in the months prior to April 1995 is not fully developed in its brief. Partners contends that the April 1995 transaction was not a significant new deal but in essence represents an agreed payment plan for past due post-petition obligations. Partners denies that the increased sales to Debtor evidence anything extraordinary and asserts instead that Partners provided goods on credit when other suppliers would not do so.

As noted above, the purchase of inventory on credit post-petition, even in amounts greater than those incurred pre-petition, does not take this relationship outside of the ordinary

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course of Debtor's business. The business dealings entered into on about April 1, 1995, do not change this conclusion. While Debtor had not converted any account payable to Partners to a promissory note before April 1, 1995, a transaction can be in the ordinary course even if it is a first time transaction. In this case, the Note entered into by Partners and Debtor does little more than take amounts admittedly due for post-petition purchases and provide that those amounts would be paid over a period of years. At the same time, the parties agreed that Debtor would make a payment of \$121,000 against other post-petition invoices that were due. The \$121,000 is a substantial sum, but there is no evidence that this amount exceeded amounts budgeted for inventory purchases. The alternative to this plan would have been for Partners to demand immediate payment of all past due post-petition invoices, a demand which Debtor was unlikely to have been able to meet under the circumstances.

Bank correctly points out that the Note adds an interest component to the credit relationship. There is no evidence, however, that the interest rate is unreasonable or outside of the ordinary course. Finally, the Note provides that future invoices will be payable on net 75 day terms. While the pre-petition purchases had been payable on net 60 day terms, the actual practice was to pay between 60 and 75 days; the Note's payment terms are, therefore, consistent with pre-petition conduct. In sum, Debtor's transactions with Partners were well within the reasonable expectations of creditors and were, therefore, within the ordinary course of Debtor's business.

IV. Retroactive Authorization

In the event that the transactions are found to be outside of the ordinary course of business, Partners asks for retroactive approval of the transactions. In light of the decision that

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the transactions were within the ordinary course, it is not necessary to address this alternative argument.

CONCLUSION

For the reasons stated, Bank's Objection to the Allowance of Partners' Administrative Claim is overruled and Partners' claim is allowed as an administrative expense under 11 U.S.C. § 503(b)(1). A separate judgment in accordance with this decision will be entered.

Date: 15 November 1996

Pat E. Morgenstern-Clarren
Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by mail on: David Simon, Esq.
Robert Burns, Esq.
Shawn Riley, Esq.

By: Joyce L. Gordon Secretary

Date: 11/15/96

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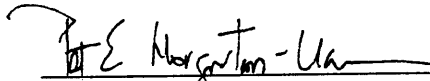
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In re:) Case No. 94-12622
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WIT & WISDOM CORPORATION,) Chapter 11
)
Debtor.) Judge Pat E. Morgenstern-Clarren
)
) **JUDGMENT**

For reasons stated in the Memorandum of Opinion filed this same date,

IT IS, THEREFORE, ORDERED that the Objection of Society National Bank to the Allowance of the Claim of Partners Book Distributing, Inc. is overruled. Partner's claim is allowed as an administrative expense under 11 U.S.C. § 503(b)(1).

Date: 15 Nov 1996



Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by mail on: David Simon, Esq.
Robert Burns, Esq.
Shawn Riley, Esq.

By: Joyce L. Gordon, Secretary

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