

# Norton Bankruptcy Law Adviser

Monthly Analysis  
of important issues and  
recent developments  
in bankruptcy law

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## DOES THE SUPREME COURT DECISION IN *DRYE* MEAN THAT A DISCLAIMER OF INHERITANCE IS A FRAUDULENT CONVEYANCE?

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### I. What is a disclaimer of inheritance?

The law in nearly every state gives the beneficiary of a bequest under either a will or intestacy statutes

the right either to inherit or to disclaim that inheritance. State law typically requires that the disclaimer be in writing and filed with the probate court or the personal representative of the estate within a certain time period following the decedent's death. If the beneficiary disclaims the inheritance then the inheritance is channeled to the disclaimer's next lineal descendant(s). A disclaimer is an irrevocable and unqualified refusal to accept a transfer. A handful of states prohibit disclaimer by an insolvent heir. See Hirsch, *The Problem of the Insolvent Heir*, 74 CORNELL L. REV. 587 (1989), for an insightful discussion of intersection of debtor-creditor law and probate law.

State law provides that the disclaimer has the same effect with respect to the disclaimed transfer as though the disclaimant died immediately prior to the effective date of the transfer. When a disclaimer is made, then, by operation of law, it relates back to the granting of the gift and treats the disclaimant as if she predeceased the donor.

### II. What are the elements of a § 548 fraudulent conveyance?

Section 548 of the Bankruptcy Code provides that the trustee may avoid any transfer of an interest of the debtor in property that was made within one year before the date of the filing of the petition:

- (a) if the debtor voluntarily or involuntarily

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The reasoning of the Supreme Court in *Drye* supports the proposition that even when a federal law requires the application of state law definitions, that deference is not unlimited. The fact that the Supreme Court addressed a split among the circuits to hold that the federal tax lien statute trumps, limits and pre-empts the state law disclaimer fiction should lead those circuits that have held to the contrary to reassess these decisions and determine that state law disclaimer fictions are not the types of state law property rights to which the bankruptcy courts must defer in applying or not applying § 548.

## THE CHAPTER 13 PLAN: A CURE-ALL FOR THE DEBTOR WHO IS NOT OBLIGATED ON A SECURED DEBT?

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More and more frequently, bankruptcy courts are encountering Chapter 13 debtors who seek to reorganize secured debt on which they are not an obligor. The issue is: Does the Bankruptcy Code permit a Chapter 13 debtor to cure prepetition arrears and reinstate a mortgage that is not the debtor's mortgage and that the debtor has not assumed?

### Fact Pattern

On March 1, 2002, the Debtor files a Chapter 13 petition and lists the property and the creditor holding the mortgage against it (hereafter "Creditor") in his schedules. Debtor's plan proposes to cure existing prepetition arrearages within 36 months and to continue making postpetition installment payments as they come due.

The mortgage was originally executed on December 1, 1999, by Borrower as obligor and Creditor as the mortgagee to secure Borrower's indebtedness to Creditor in the principal amount of \$100,000.00. Borrower defaulted on the mortgage by failing to make payments when due, and then deeded the property to Debtor. The transfer was recorded. Just before the filing of Debtor's Chapter 13 case, Creditor had commenced foreclosure proceedings by applicable state law procedures.

Creditor now objects to Debtor's plan on the following grounds:

1. The prepetition transfer from Borrower to Debtor without the prior written consent of Creditor violated the due on sale clause contained in the mortgage, and Debtor's plan does not, and cannot, cure that default; and

2. Debtor did not assume the mortgage and is not personally liable to Creditor, so the debt is not subject to reorganization.

### Preliminary Analysis

In Chapter 13, the debtor may file a plan that modifies the rights of holders of secured claims, unless the claim is secured only by a security interest in real property that is the debtor's principal residence. 11 U.S.C. § 1322(b)(2). The plan can provide for the curing or waiving of any default. § 1322(b)(3). For obligations that require payments after the expiration of the plan term, the plan may modify the rights between the parties to provide for a cure of a default within a reasonable time even if the claim is solely secured by the debtor's principal residence. The debtor also must maintain the regular payments. § 1322(b)(2).

In this case there are at least two defaults that Debtor needs to remedy: (1) default arising out of failure to pay the debt in accordance with the terms of the contract; and (2) the default arising out of unauthorized transfer of the property to Debtor in violation of a due on sale clause in the note and mortgage. The question is whether Debtor can force Creditor to forego its remedies for breach of the due on sale clause. If Debtor cannot defeat the due on sale clause, then the plan will not be able to cure the second default.

### Debtor's Right to Cure Defaults

Most states allow a lender to accelerate a mortgage if the obligor fails to tender a payment. Notwithstanding such state law rights, the Bankruptcy Code allows debtors to deaccelerate the note and reorganize it in a Chapter 13 plan under § 1322(b)(3), and such federal law supersedes state law property rights. *See, e.g., In re Metz*, 820 F.2d 1495, 1499 (9th Cir. 1987); *In re Nelson*, 59 B.R. 417, 419-20 (B.A.P. 9th Cir. 1985). Therefore, had Borrower filed a Chapter 13 petition after defaulting on the loan, Borrower, as the obligor on the note, would have had the ability through the plan to cure the arrears and reinstate the mortgage.

However, Debtor is not the Borrower. This requires an analysis of what right a debtor has to modify a debt for which the debtor is not personally liable.

### The Johnson Decision

Prior to the Supreme Court decision in *Johnson v. Home State Bank*, 501 U.S. 78, 111 S. Ct. 2150, 115 L. Ed. 2d 66 (1991), courts generally held that "without privity of contract there is no debtor-creditor relationship and therefore an assignee may not cure the assignor's default through the plan." Bruce

H. White & Maria H. Belfield, *May a Debtor Cure a Mortgage Default to Which He Is Not a Party Through a Chapter 13 Plan?*, 17 AM. BANKR. INST. J 22 (1998).

In **Johnson**, the Supreme Court was faced with the issue "whether a debtor can include a mortgage lien in a Chapter 13 bankruptcy reorganization plan once the personal obligation secured by the mortgaged property has been discharged in a Chapter 7 proceeding." Johnson gave a mortgage to secure promissory notes to Home State Bank (the "Bank"). When Johnson defaulted on these notes, the Bank commenced foreclosure proceedings in state court. Thereafter Johnson filed a Chapter 7 petition in which the Bank moved for and was granted relief from the automatic stay. After reinitiating state court foreclosure proceedings, the Bank was awarded an *in rem* judgment and proceeded to schedule a foreclosure sale. Before the scheduled date of sale, Johnson filed a petition under Chapter 13 and listed the Bank's mortgage as a claim against his estate.

To reach the conclusion that the now non-recourse mortgage remains a debt in the subsequent Chapter 13 case, the Court started with the Code's definition of "claim" in § 101(5) as a "right to payment." It then applied its previous conclusion in **Pennsylvania Department of Public Welfare v. Davenport**, 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588 (1990), that "'right to payment' [means] nothing more nor less than an enforceable obligation." The Court concluded that "a mortgage interest that survives the discharge of a debtor's personal liability is a 'claim' within the meaning of §101(5)." **Johnson**, 501 U.S. at 84, 111 S. Ct. at 2154. After pointing out that the prior Chapter 7 discharge extinguished only the *in personam* liability of the debtor but not the Bank's *in rem* rights against its collateral, the Court noted that "§ 502(b)(1) contemplates circumstances...which...may consist of nothing more than an obligation enforceable against the debtor's property" and that "§ 102(2) establishes, as a '[r]ul[e] of construction,' that the phrase 'claim against the debtor' includes claim against property of the debtor." *Id.* Thus, the Court concluded that the mortgage that survived the Chapter 7 discharge of the debtor's personal liability could be treated in the *same* debtor's subsequent Chapter 13 plan, even though the debtor was not personally liable for the debt.

### Post-Johnson Split Among the Courts

Since **Johnson**, more courts have allowed non-obligors to reorganize mortgage arrearages through Chapter 13 plans, although a split amongst the courts remains. The courts that have allowed debtors to reorganize non-obligor secured debt have relied on the

language in **Johnson**, concluding that a mortgage debt is an *in rem* claim against the estate that is subject to reorganization despite the debtor's lack of personal liability for the debt. *See, e.g., In re Garcia*, 276 B.R. 627 (Bankr. D. Ariz. 2002) (debtors entitled to cure breach of due on sale clause; this case is examined in greater detail below); **In re Trapp**, 260 B.R. 267 (Bankr. D.S.C. 2001) (mortgagee held claim against estate even though no privity of contract existed); **In re Rutledge**, 208 B.R. 624 (Bankr. E.D.N.Y. 1997) (purchaser in violation of due on sale clause may cure); **In re Allston**, 206 B.R. 297 (Bankr. E.D.N.Y. 1997) (debtors owned property as to which mortgagee held lien and such property was estate property; thus, mortgagee held "claim" against debtors' estate, even though no privity of contract existed between mortgagee and debtors, and debtors could repay that "claim" as part of their Chapter 13 plan); **In re Hutcherson**, 186 B.R. 546 (Bankr. N.D. Ga. 1995) (by virtue of transfer of ownership from the mortgagor-mother to the debtor-daughter, the mortgagee did hold a "claim" against the debtor-daughter's estate in bankruptcy, even though no privity of contract ever existed between mortgagee and debtor); **In re Lumpkin**, 144 B.R. 240 (Bankr. D. Conn. 1992) (even though Chapter 13 debtor acquired the property from her mother without assuming mortgage, the *in rem* "claim" of the mortgagee was a "claim" subject to inclusion in a Chapter 13 plan). [See Norton Bankr. L. & Prac. 2d §§ 121:8, 121:8 (Supp).]

The courts that have continued to disallow the practice of non-obligors reorganizing their debts have distinguished their cases from **Johnson** by finding that the debtor in **Johnson** was the original obligor and that without privity of contract there is no debtor-creditor relationship and therefore an assignee may not cure the assignor's default. They have also interpreted **Johnson** to apply only to the facts set forth in that case, namely in "Chapter 20" situations. White & Belfield, 17 AM. BANKR. INST. J at 23. *See, e.g., In re Parks*, 227 B.R. 20 (Bankr. W.D.N.Y. 1998) (debtor cannot "cure" someone else's defaults under contract to which he or she was not party, nor may debtor "cure" defaults that would not restore debtor to an enforceable status under contract or law"); **In re Kizelnik**, 190 B.R. 171 (Bankr. S.D.N.Y. 1995) (mortgagor's granddaughter did not have standing, in her capacity as tenant on mortgaged property with alleged option to purchase, to intervene in dispute between her grandfather and the mortgagee, to decelerate long-defaulted mortgage loan and to invoke automatic stay to prevent mortgagee from foreclosing); **In re Martin**, 176 B.R. 675 (Bankr. D. Conn. 1995) (debtor obtained property contrary to due on

sale clause, debtor is not in privity with the bank, and debtor's plan impermissibly seeks to modify bank's rights in violation of § 1322); **In re Mitchell**, 184 B.R. 757 (Bankr. C.D. Ill. 1994) (in granting mortgagee's motion to lift the automatic stay in order to foreclose on property mortgaged by third party but owned and occupied by Chapter 13 debtor, the court found no compelling equitable considerations which would mandate the imposition of a debtor-creditor relationship upon the debtor and the mortgagee); **In re Threats**, 159 B.R. 241 (Bankr. N.D. Ill. 1993) (debtors who had obtained residential property from the original mortgagors without adhering to a due-on-sale clause were not permitted to cure defaults through a Chapter 13 plan); **In re Wilkinson**, 99 B.R. 366 (Bankr. N.D. Ohio 1989) (debtors could not cure the arrearage on mortgage through their Chapter 13 plan because the debtors were not personally liable on the underlying mortgage taken out by the parent); **In re Jones**, 98 B.R. 757 (Bankr. N.D. Ohio 1989) (debtor's plan may not provide for the curing of a mortgage default because there exists no creditor-debtor relationship between the mortgagee and the debtor, who is not liable on the mortgage); **In re Taylor**, 96 B.R. 584 (Bankr. E.D. Pa. 1989) (in the context of a § 506(a) proceeding to reduce the secured portion of mortgagee's claim, the court doubted whether a unilateral transaction between a grantor-mortgagor and a grantee-debtor can bind the mortgagee to accept the grantee-debtor as the mortgagor); **In re Everhart**, 87 B.R. 35 (Bankr. N.D. Ohio 1988) (generally, without an attendant liability on a mortgage note, there can be no cure of a default by a third party who has made payments thereon without an assumption of the mortgage; but, under unique factual circumstances presented, equity required that the Chapter 13 debtor be allowed to cure the defaults on the mortgage note even though she lacked privity on the mortgage); **In re Kelly**, 67 B.R. 508 (Bankr. S.D. Miss. 1986) (original borrower's transferee could not cure original borrower's default through Chapter 13 plan, since there was no debtor-creditor relationship between Chapter 13 debtor and the mortgagee).

### Garcia

The **Garcia** case warrants further discussion as it reviews the existing case law discussed above. The debtors in **Garcia** acquired title to real property by purchasing it from the borrower's probate estate. The underlying note was neither assumed by the debtors nor did the bank consent to the transfer. The debtors made several payments to the bank, which negotiated these payments. Debtors subsequently defaulted and filed Chapter 13. The bank never gave notice to any interested party that it intended to accelerate its

note pursuant to the existing due on sale clause. The bank moved for relief from the automatic stay. Central to the court's decision in **Garcia** are the facts that the debtors actually paid money for their acquisition of the property, that they made payments for some period of time (prepetition) which were accepted by the bank and that the bank never exercised its right to accelerate the note based upon a due on sale clause. These facts led the court to find that "there is [no] allegation that the Debtors acted in bad faith either in acquiring the property or in filing this Chapter 13 case." **Garcia**, 276 B.R. at 629.

The court went on to find that the debtors did have a relationship with the lender because the Code recognizes such a relationship whenever a creditor holds a claim secured by the debtor's property, even if the debtor has no personal liability, citing **Johnson**. **Garcia**, 276 B.R. at 631. The court did not limit the holding in **Johnson** to that of a "Chapter 20" case as have other cases such as **Kizelnik** and **Mitchell**. **Garcia**, 276 B.R. at 632. The court also found that a debtor-creditor relationship existed under state law because Arizona law provides that "the subsequent purchaser is specifically given the right to bring payments current and to cur[e] all other defaults." *Id.* Lastly, the court found that the deed of trust itself created a debtor-creditor relationship by including language to the effect that the provisions contained therein are binding on all successors of both the original lender and the original borrower. Relying on both the Code and state law, the court found that a debtor-creditor relationship existed.

The court then determined that the curing of the unauthorized transfer was permissible because § 1322(b)(3) and (b)(5) provide for the curing of *any* default. **Garcia**, 276 B.R. at 635 (emphasis in original). It found that the default can be cured by complying with the Code's confirmation requirements. *Id.* at 640. The purpose of a cure is to restore the lender to a predefault situation, so the debtor must compensate the lender for any loss as a result of the default. *Id.* As the bank accepted money from the debtors, the court found that the cure of the due on sale clause could be achieved monetarily.

### The Better Analysis

The better line of reasoning is in those cases that disallow a non-obligor to reorganize the debt through Chapter 13 bankruptcy. **In re Parks**, 227 B.R. 20 (Bankr. W.D.N.Y. 1998), is a good example.

The debtor in **Parks** was an executor of his deceased father's estate and deeded his father's mortgaged house to himself and his sister and filed a Chapter 13 petition before a foreclosure sale could

be completed. The debtor proposed to pay off the entire outstanding mortgage balance over the life of the plan.

The **Parks** court first noted that any ability to reorganize the debt had to be found in § 1322(b), (c) or (e). The court stated that the "any default" language in § 1322(b)(3) cannot mean literally *any* default, but must be constrained to refer to something connected with the debtor or the debtor's property. **Parks**, 227 B.R. at 23. The court looked to the dictionary definitions of the word "cure," and determined that its plain meaning was one of revival. "To revive an agreement under which the debtor has no rights, or to revive a legal status that only someone other than the debtor may assert, is nonsensical." *Id.* The court went on to state:

A common-sense interpretation requires that only a right or status lost by the debtor may be "cured"; and once cured, there must be no new *ipso facto* default. In other words, this Debtor may not "cure" someone else's defaults under a contract to which he was neither a party nor a third-party beneficiary, nor may he "cure" or "waive" defaults that would not restore this Debtor (rather than his father) to an enforceable status under contract or law.

*Id.*

Examining the debtor's right to modify the debt under § 1322(b)(2), the court found that the reach of the statute cannot extend to include modification of a secured claim already in place when the debtor equitably or legally acquired the property. *Id.* at 25. The court concluded that the debtor could not cure or modify his father's debt in his Chapter 13, because "a debtor brings into a Code case nothing more than the debtor had." *Id.*

This axiom was noted in other cases cited above. For example, both the **Threats** and **Martin** opinions stated: "The Bankruptcy Code allows debtors to retain certain previously held interests in property-it does not allow them to create new ones." **Martin**, 176 B.R. at 677 (quoting **Threats**, 159 B.R. at 243).

Consequently those courts held that absent any state law forbidding due on sale clauses, debtors could not reorganize debts where they did not have any personal obligation.

The **Garcia** case can be distinguished because the debtors in that case acquired the property by paying some consideration for it. The **Garcia** court made a finding that the debtors had acted in good faith in filing their petition and proposing their plan. The court further noted that "[n]othing in Arizona law suggests

that violation of a due on sale clause, at least by a *responsible* buyer, is inherently incurable." **Garcia**, 276 B.R. at 642 (emphasis added). **Garcia** was therefore different from most debtors in the reported cases who have acquired the property for a single purpose-to frustrate the lender by invoking the automatic stay. Further, the court in **Garcia** acknowledged that the essence of cure is to restore a lender to a predefault situation. By imposing a new borrower on a lender, the court has not restored the parties to their respective position prior to the default. Lastly, this author cannot expand the holding in **Johnson** beyond a debtor who files successive cases as some courts, including **Garcia**, have urged.

### Validity of Due on Sale Clauses

The **Martin** opinion also noted that the debtor had failed to show that the due on sale clause was unenforceable under state law. **Martin**, 176 B.R. at 677. But that issue is now largely governed by federal law, which upholds the validity and enforceability of due on sale clauses.

In 1982, Congress enacted the Garn-St. Germain Depository Institutions Act. Section 341 of the Act, which is codified at 12 U.S.C. § 1701j-3, broadly preempts state laws that restrict the enforcement of due on sale clauses, thereby making such clauses generally enforceable. Grant S. Nelson and Dale A. Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of The Garn-St. Germain Act*, 35 HASTINGS L.J. 241, 259 (1983).

The Act covers any "person or government agency making a real property loan." 12 U.S.C. § 1701j-3(a)(2). According to the Regulation the foregoing definition includes: individuals, Federal associations, state chartered savings and loan associations, national banks, state chartered banks and state chartered mutual savings banks, Federal credit unions, state chartered credit unions, mortgage banks, insurance companies and finance companies which make real property loans, manufactured home retailers who extend credit, agencies of the Federal government, and any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act. Nelson and Whitman, *supra*, 35 HASTINGS L.J. at 261-262.

After the Garn-St. Germain Act, the only remaining limitations on enforcement of due on sale clauses are (1) the state law rule that foreclosure, even by exercise of a due on sale clause, will not be ordered if to permit it would be unconscionable or inequitable; and (2) restrictions in the Garn-St. Germain Act itself, codified at 12 U.S.C. § 1701j-

3(d). John P. Ludington, *Validity and Enforceability of Due on Sale Real Estate Mortgage Provisions*, 61 A.L.R. 4th 1070 (1988).

**Conclusion**

Although Chapter 13 debtors may cure defaults that relate to the failure to make installment payments, they should not be able to reorganize debts on which they are not an obligor. There may be certain situations where, like the debtors in *Garcia*, a good faith inquiry under the Code and applicable state law yield a contrary result, but this should be the exception not the norm. Courts should seek to prevent these debtors from reorganizing such debts as their inclusion in plans serves only to frustrate secured lenders and not to promote the spirit of the Code of allowing honest debtors a fresh start and a chance to reorganize *their* debts.

**OBJECTIVE ORDINARINESS UNDER § 547(c)(2)(C): IS IT MERELY A BATTLE OF EXPERTS?**

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**I. Introduction**

In preference litigation, to succeed under the ordinary course of business defense, the creditor has the burden of proving three elements of § 547(c)(2) by a preponderance of evidence. The creditor or transferee must prove that the transfer was:

- (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
- (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
- (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2)(A)-(C). A majority of Circuit Courts agree that the defendant's burden includes proof of subjective ordinariness between the parties under § 547(c)(2)(B) and objective ordinariness in the industry in which the parties transact business under § 547(c)(2)(C).

The practical issue bankruptcy litigators face is how to demonstrate subjective and objective ordinariness. This article addresses the objective prong of the ordinary course of business defense in § 547(c)(2)(C). A majority of the reported decisions support the view that proof of this element is a battle of experts; how-

ever, there is case law support for some uncertainty with respect to the evidence necessary to prove ordinary business terms under the preference statute. [See Norton Bankr. L. & Prac. 2d §§ 57:19, 57:19 (Supp.).]

**II. The Burden Of Proving Ordinary Business Terms**

In *In re Tolona Pizza Products Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993), the Seventh Circuit explained 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)." Courts have concluded that *Tolona Pizza* "requires the creditor to present some evidence of the practices of its competitors in order to establish the 'ordinary business terms' in the industry." See, e.g., *Solow v. Ogletree, Deakins, Nash, Smoak & Stewart (In re Midway Airlines, Inc.)*, 180 B.R. 1009, 1016 (Bankr. N.D. Ill. 1995).

The Fourth Circuit developed a sliding scale test under § 547(c)(2)(C), adopting both *Tolona Pizza* and *Fiber-Lite Corp. v. Molded Acoustical Products, Inc. (In re Molded Acoustical Products, Inc.)*, 18 F.3d 217 (3d Cir. 1994). The Fourth Circuit held that the sliding scale approach should be used to determine whether the transaction between the debtor and transferee is consistent with industry norm. In *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044, 1049 (4th Cir. 1994) (citing *Molded Acoustical*, 18 F.3d at 225-26), the Fourth Circuit stated:

A 'sliding-scale window' is thus placed around the industry norm. On one end of the spectrum, '[w]hen the relationship between the parties is of recent origin, or formed only after or shortly before the debtor sailed into financially troubled seas, the credit terms will have to endure a rigorous comparison to credit terms used generally in a relevant industry.' In such a case, only those 'departures from [the] relevant industry's norms which are not so flagrant as to be 'unusual' remain within subsection C's protection.

The Sixth Circuit has stated that the "clear consensus among the courts of appeals" is that 'ordinary business terms' under § 547(c)(2)(C) "means that the transaction was not so unusual as to render it an aberration in the relevant industry." *Luper v. Columbia Gas of Ohio, Inc. (In re Carled, Inc.)*, 91 F.3d 811, 818 (6th Cir. 1996). The court rejected the holding of the district court that the appropriate test under § 547(c)(2)(C) requires "that the transactions at issue resemble a majority of the industry's transactions."