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'Ordinary Course Of Business' In Debt Agreements

Law360, New York (June 22, 2010) -- Many credit agreements, indentures and other institutional debt agreements include the limiting phrase "in the ordinary course of business," often in the context of exceptions from prohibitive (or "negative") covenants in the agreement.

For example, a debt agreement may prohibit the borrower from granting a lien on any of its assets, with an exception for "liens arising in the ordinary course of business."

Similarly, the agreement may stipulate that the borrower may not sell any of its assets, except for "sales in the ordinary course of business."

Such exceptions presumably are intended to allow the debtor to operate its business in an ordinary or usual manner without exposing the creditor to an undue risk of loss, such as would occur if the debtor were to take on major liens securing debt or sell assets that are important from a credit perspective.

Black's Law Dictionary defines "ordinary course of business" as the "normal routine in managing trade or business."[1]

As discussed below, if a company has engaged in a particular transaction many times before, it may be easy to conclude that doing so again is "in the ordinary course of business." However, more difficult determinations often arise.

For example, if the borrower has never granted a specific type of lien, but the practice is common in the industry, would the lien "arise in the ordinary course of business?"

Similarly, if a company sells excess inventory, which it has done before only on infrequent occasions, should that sale of assets be considered "in the ordinary course of business?"

Despite the fact that the phrase is commonly used in debt agreements, its meaning is usually left undefined in the agreement, and case law interpreting the phrase is sparse in the context of debt agreements or other contracts.

The phrase is more frequently used in other contexts, including bankruptcy, tax and commercial law, and a court might look to those areas for guidance in defining the meaning of "ordinary course of business" in a debt agreement.

Courts interpreting the phrase in contracts and these other areas have considered a number of factors, including: historical practices of the parties, common practices in the industry, frequency of past transactions, substantiality of a sale, and whether a transaction relates to the main purpose of the business.

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What follows is a summary of the case law we have found that may be relevant to the interpretation of this phrase in the context of a debt agreement, as well as a discussion of a few hypothetical situations.

Case Law

Courts interpreting the phrase “ordinary course of business” in the context of a nondebt contract have looked at whether the transaction was “something which is done as a matter of corporate historical practice.”[2]

Courts have analogized the term to a course of dealing, which is “a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.”

In Unisys, the plaintiff sold a subsidiary to the defendant and agreed to continue funding the company during the transition period “in the ordinary course of business.” The plaintiff sought to recover funds it had advanced to the subsidiary on the theory that the funds constituted an intercompany loan that was meant to be paid back.

The defendant argued that the cash advancement fell within the plaintiff’s obligations to continue funding the subsidiary. The court looked to the historical practice of the plaintiff and found that, since it had been advancing funds to the subsidiary for several years, the practice was “ordinary course” and plaintiff had to continue doing so during the transition period.

In another contracts case the parties, in connection with a potential sale of one of the plaintiff’s subsidiaries to the defendant, agreed not to initiate contact or engage in discussions with any employee of the subsidiary, except for “normal and routine contacts made in the ordinary course of business consistent with past practice.”[3]

The plaintiffs alleged that this provision was violated when the defendant became involved in contract renegotiations with some employees. The court held that this was not outside the ordinary course of business because the contact involved existing employees who had been involved in contract negotiations in the past.

In other contracts cases, courts have found that a variety of transactions can occur in the ordinary course of business when such transactions are normal and routine. In such cases, the court did not examine the past practices of the parties but simply declared the transactions “ordinary course,” presumably because they were not unusual or unexpected. This is similar to the “normal routine” definition in Black’s Law Dictionary.

For example, in Davis, an oil company leased state land with the obligation to cap and clean the oil rigs at the expiration of the lease.[4]

The company subsequently assigned the lease, with the assignee assuming “all obligation and liabilities of the assignor at the effective date that have arisen in the ordinary course of business.” The court stated, without explanation, that the duty to cap and clean the rig arose in the “ordinary course.”

In another case, two parties entered into an agreement to transfer a portion of the defendant’s business to the plaintiff, and the plaintiff claimed that the defendant broke a promise to continue operating the subsidiary “in the ordinary course of business” by accelerating the collection of accounts receivable.[5]

The court stated, in dicta, that accelerating accounts receivable would not prevent the transaction from being considered “in the ordinary course.”

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Courts have also considered the phrase “ordinary course of business” in a number of other contexts. For example, the provisions of the United States Internal Revenue Code allow a taxpayer to receive favorable capital gains treatment for gains from the sale of an asset when it is classified as a capital asset.

Property that is held primarily for sale to customers “in the ordinary course of business” is not considered a capital asset and the sale of such property creates ordinary income, rather than capital gains.[6]

In determining whether a sale fits within the “ordinary course” language, courts have considered, among other things, “the continuity of sales or sales-related activity over a period of time, the number and frequency of sales, the substantiality of sales” and the overall history of the operation.[7]

Cases interpreting the capital gains provisions of the code may not be persuasive precedent for the interpretation of the phrase under debt agreements, however, since the purposes of the code provisions are quite different from the purposes of comparable language in debt agreements.

The Uniform Commercial Code allows a “buyer in ordinary course of business” to purchase an asset free from any existing security interests. Section 1-201(9) of the UCC defines “buyer in ordinary course of business” as someone “that buys goods in good faith … in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind.”

The code definition further states that “a person buys goods in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices.”

The definition, as such, presumably has little value for the interpretation of “ordinary course” language in debt agreements since it merely defines what is considered “ordinary course” for purposes of the UCC provisions. On the other hand, cases interpreting that definition may be somewhat helpful since one prong of the definition is quite similar to the test enunciated in Unisys.

Section 547(c) of the Bankruptcy Code provides a defense to a preference action if the debtor made the challenged preference payment in the ordinary course of its business. This defense is intended to encourage creditors to continue dealing with, and extending credit to, financially distressed companies.

Amendments to the Bankruptcy Code made in 2005 allow the defense to be raised if the debtor’s payment was made either: (1) in the ordinary course of business, or (2) according to ordinary business terms.

Prior to these amendments, the defense was only available if the payment was made both in the ordinary course of business and according to ordinary business terms, and this was collectively referred to as the “ordinary course of business” defense.

Also, Section 363(c) of the Bankruptcy Code requires court approval before a debtor-in-possession may sell property during a bankruptcy proceeding, unless the transaction occurs “in the ordinary course of business.”

Courts often employ two tests to determine whether a transaction is in the ordinary course of business for purposes of the Bankruptcy Code: “(1) the creditor's expectation test, also known as the vertical test, and (2) the industrywide test, also called the horizontal test.”[8]

Under the tests, “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.”[9]

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Under the vertical test, the court "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 enter into a contract with the debtor."[10]

The horizontal test, by contrast, concerns "an industrywide perspective in which the debtor's business is compared to other like businesses."[11] Given the focus on expectations of the parties and the risks to creditors, it is arguable that cases under these provisions of the Bankruptcy Code are useful precedent for the interpretation of the phrase in the contractual context.

Certain Issues

Disputes could arise over whether historical practices were frequent or predominant enough to be considered "ordinary course."

Under UCC Section 1-201(9), courts have held that a sale transaction need not be the predominant business of the seller to be considered ordinary course and that a sale that is only incidental to the main business of the seller can still be considered ordinary, so long as it relates to its predominant business.

Similarly, an infrequent sale of assets could still be ordinary course if it relates to the main purpose of the business. For example, courts have held that a sale of excess inventory to a competitor occurred in the ordinary course of business of the seller, as did the sale of a used vehicle by a car rental company.[12]

As noted above, frequency is also a factor when determining if a sale should be classified as a sale of a capital asset for tax purposes.

In the context of debt agreements, infrequent transactions may still be considered "ordinary course." UCC Section 1-201(9) seems to focus on the buyer's expectations, and the Bankruptcy Code provisions referenced above seem to focus on parties' expectations as well.

Similarly, an exception in a debt agreement to engage in "ordinary course" transactions may well be intended to permit the borrower to engage in transactions that the lenders would reasonably expect.

Arguably, it should be expected that the borrower would sometimes have to engage in certain activities that are infrequent but important to the central mission, such as selling excess goods, so that these should be allowed under a debt agreement exception for transactions "in the ordinary course of business."

A more difficult issue arises when a transaction is one that the company has never undertaken before. If a court were only to look to a company's historical practices, then such a transaction obviously would not be in the ordinary course. Likewise, it may be difficult to argue that such a transaction is "normal or routine."

However, debt agreements often include both the phrases "in the ordinary course of business" and "consistent with past practices," implying that these two have different meanings. If "in the ordinary course of business" is something other than consistent with past practice, could it be interpreted to include a transaction that has never been undertaken before?

In several cases arising under the Bankruptcy Code, courts have held that a first-time transaction could meet the "ordinary course of business" requirement because "[o]bviously every borrower who does something in the ordinary course of her affairs must, at some point, have done it for the first time."[13]

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It is unclear whether a court would apply similar reasoning in the context of a debt agreement. However, the case for such an interpretation seems stronger if the agreement contains in addition to exceptions for transactions "in the ordinary course of business," exceptions for transactions "consistent with past practices."

Conclusion

Given the common usage of the phrase "ordinary course of business" in debt agreements, issues arise frequently as to whether transactions occur in the "ordinary course." If the company has a long-standing practice of engaging in such transactions, a court is likely to find that this meets the ordinary course requirements.

The outcome is less clear when the past practice is sporadic or if the company has never undertaken the transaction in question. Looking at the interpretation of the "ordinary course of business" terminology in contexts other than contracts, while helpful to some extent, ultimately does not provide a conclusive answer.

In addition, the language of the particular provision and the debt agreement as a whole need to be carefully analyzed to determine whether the particular transaction is intended to be covered by the provision in question.

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[1] Black's Law Dictionary 1209 (9th ed. 2009).

[2] Unisys Corp. v. Hercules Inc., 224 A.D.2d 365, 368 (N.Y. App. Div. 1996).

[3] Preferred Care Partners v. Humana, case number 08-20424-CIV, 2009 WL 982433, at *8 (S.D. Fla. April 9, 2009).

[4] Davis Oil Co. v. TS Inc., 145 F.3d 305, 313 (5th Cir. 1998).

[5] Phoenix Technologies v. TRW Inc. 840 F. Supp. 1055, 1065 (E.D. Pa. 1994).

[6] Commissioner v. Gillette Motor Transport Inc., 364 U.S. 130 (1960).

[7] Grober v. Commissioner, 1972 Tax Ct. Memo LEXIS 17, 50 (1972).

[8] In re Lavigne, 114 F.3d 379, 384 (2d Cir.1997).

[9] Id. at 384-85.

[10] Id. at 385.

[11] Id.

[12] Tanbro Fabrics Corp. v. Deering Milliken Inc., 39 N.Y.2d 632 (1976); Bontemps v. Bank of Babylon, 96 A.D.2d 1025 (N.Y. App. Div. 2d Dep't 1983).

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[13] Gosch v. Burns, 909 F.2d 903, 908 (6th Cir. 1990).

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