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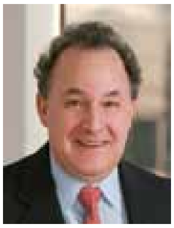

A Preference Split Decision on the New Value and Ordinary Course of Business Defenses: Win Some, Lose Some!

Trade creditors often dread getting a demand to repay a preference claim or being named as a defendant in a preference action. To make matters worse, certain defenses to a preference claim are often fact-intensive as well as very difficult and expensive to prove.

The decision of the U.S. Bankruptcy Court for the District of Delaware in *AFA Investment Inc.* addresses the new value and ordinary course of business defenses, two of the most frequently raised preference defenses. The court followed two prior Delaware bankruptcy court holdings that allowed a preference defendant to rely on both unpaid and paid new value when calculating its subsequent new value defense. The decision also included a thorough analysis in denying the applicability of the ordinary course of business ("OCB") defense.

Preference Defenses

A trustee must satisfy all of the requirements of Bankruptcy Code Section 547(b) to avoid a preferential transfer. The burden then shifts to the defendant to prove one or more of the preference defenses contained in Section 547(c).

A creditor must first prove that an alleged preference paid indebtedness incurred in the ordinary course of the debtor's and creditor's business or financial affairs. This requirement is easy to prove based on the creditor's prior extension of trade credit to the debtor.

The new value defense, contained in Section 547(c)(4), reduces a creditor's preference exposure to the extent the creditor had replenished the debtor, by providing new goods or services, after receiving the preference. The new value defense disallows new value that was paid *by an otherwise unavoidable transfer to or for the creditor's benefit*. Simply put, paid new value can be counted as a preference defense if it is paid by an avoidable preference or other transfer. It will not reduce preference liability if the payment itself is not avoidable as a preference or otherwise.

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The courts are divided over whether the Section 547(c)(4) new value defense includes paid new value as they have interpreted the meaning of Section 547(c)(4)(B)'s requirement that the new value asserted as a preference defense cannot be paid by an *otherwise unavoidable transfer to or for the benefit of the creditor* in conflicting ways. The *AFA Investment* decision is significant because it is now the third holding by the Delaware Bankruptcy Court (the venue of choice for many large commercial Chapter 11 filings) to allow a preference defendant to rely on paid new value when determining its new value defense.

Another preference defense is the OCB defense contained in Section 547(c)(2) of the Bankruptcy Code. A creditor must first prove that an alleged preference paid indebtedness incurred in the ordinary course of the debtor's and creditor's business or financial affairs. This requirement is easy to prove based on the creditor's prior extension of trade credit to the debtor. The creditor must then prove that the payment was *either* (1) made in the ordinary course of the debtor's and creditor's business or financial affairs, the *subjective* component of the OCB defense, or (2) made according to ordinary business terms, the *objective* portion of the defense.

A creditor satisfies the subjective part of the OCB defense by proving that the alleged preference payment was made in the ordinary course of the debtor's and creditor's businesses. That requires proof of some consistency between the alleged preference payments and the debtor's and creditor's payment history and other aspects of their relationship. Courts analyzing the subjective part of the OCB defense have considered one or more of the following factors: (i) the length of the parties' business relationship; (ii) the amount and timing of the debtor's payments both during and before the preference period; (iii) the manner of payments (e.g., check, wire transfer, etc.) both before and during the preference period; (iv) any unusual action by either the debtor or creditor concerning payment or collection of the creditor's claim; and (v) whether the creditor did anything to obtain an advantage in light of the debtor's deteriorating financial condition. The *AFA Investment* court focused on the timing of the debtor's payments prior to and during the preference period.

A creditor can also prove the OCB defense by satisfying the "ordinary business terms" or objective prong of the defense. That requires proof of the consistency of the alleged preference payment with the payment practices and range of terms in the creditor's industry (according to the *AFA Investment* court), the debtor's industry, or some subset of either or both.

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Background

AFA Investment Inc. and certain affiliates (collectively, the "Debtors"), one of the largest ground beef processors in the United States, filed their Chapter 11 petitions on April 1, 2012 (the "Petition Date"). The Debtors' business relationship with the preference defendant, Smith & Sons Meat Packing Company (the "Defendant") started in 2005. During the 90-day preference period (the "Preference Period")—from Jan. 3, 2012 through and including April 2, 2012—the Defendant received 25 payments, totaling $2,273,500 (the "Alleged Preferences") from the Debtors. On April 16, 2014, the Debtors filed a complaint seeking to avoid and recover the Alleged Preferences. The Defendant answered the complaint. Two preference defenses, the new value and OCB defenses, were at issue in the lawsuit. The Debtors then moved for summary judgment, seeking to avoid and recover $215,664.61 of the Alleged Preferences (the "Remaining Preference Payments").

The Bankruptcy Court's Decision

The court first addressed the new value defense. The court held that the defense included both (a) unpaid, and (b) paid invoices (since the paid invoices were not themselves paid by an "otherwise avoidable transfer"), leaving a net preference claim of $215,664.61.

The court then held that neither the subjective nor objective prong of the OCB defense shielded the Defendant from liability on the Remaining Preference Payments. The court relied on the timing of payments in holding that the Remaining Preference Payments did not satisfy the subjective component of the OCB defense. The near doubling of the average timing of payments, when comparing those made during the historical period—approximately one-year prior to the preference period (the "Historical Period")—to the payments during the Preference Period, demonstrated that the Debtors had changed the way they were doing business with Defendant.

The court was persuaded by the Debtors' argument that 97% of all invoices were paid during the Historical Period between 16 and 30 days after invoice date, while 96% of the invoices paid during the Preference Period were paid more than 30 days after invoice date. Likewise, none of the approximately $13 million of payments during the Historical Period were paid later than 35 days after invoice date. However, during the Preference Period, 71.7% of invoices were paid 35 or more days after the invoice date. Finally, the court relied on the near doubling of the weighted average days to pay invoices during the Preference Period, 43.95 days, compared to the only 22.43 weighted average days to pay during the Historical Period.

The court rejected the Defendant's argument that it had satisfied the subjective OCB defense based on the Debtors' consistently late payments to Defendant prior to the Preference Period. That is simply not the end of the story where there was a material slowdown in the Debtors' payments to Defendant during the Preference Period.

The court also rejected the Defendant's argument that the Remaining Preference Payments were shielded by the objective part of the OCB defense. The court first considered the ordinary business terms utilized in the Defendant's industry.[1] The parties' experts agreed on the Defendant's industry (Animal [except Poultry Slaughtering]) and sales class/annual sales amount ($50 million to $99.99 million of sales).

The Defendant's expert concluded that the Remaining Preference Payments, ranging from 27 to 59 days after invoice date, satisfied the objective part of the OCB defense. The expert relied on certain data from BizMiner, a leading producer of industry statistical reports. The BizMiner data showed that

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the average number of days that receivables were outstanding ("DSO") in the Defendant's industry (regardless of annual sales amount) was 51.18 days in 2010, 46.25 days in 2011 and 22.25 days in 2012. The expert also relied upon the BizMiner report that only included companies in the Defendant's sales class/annual sales amount and observed that the DSO for 2010, 2011 and 2012 was 41.96 days, 43.16 days and 17.46 days, respectively. The expert attributed the improvement in DSO from 2010 through 2012 to the improving timing of collections in Defendant's industry. The expert also reviewed data from the Risk Management Association ("RMA"), a publisher of annual statement studies in which financial ratio benchmarks are reported by industry participants. The RMA data included information pulled from financial statements between April 1, 2010 and March 31, 2011, and included a median DSO of 27 days, with most firms reporting a DSO of between 17 and 30 days.

The Debtors' expert, relying on the same sources of data, concluded that the objective OCB defense did not apply to shield Defendant from preference liability. The Debtors' expert rejected the Defendant's expert's reliance on industry data from 2010 and 2011 because the Remaining Preference Payments were made in 2012 when payments in Defendant's industry were made considerably faster.

The court rejected the applicability of the objective OCB defense based on the Debtors' expert's analysis. The court criticized the Defendant's expert's reliance on BizMiner industrywide data (not broken out by annual sales) for the Defendant's industry from 2010, a period where industrywide DSO (45 days) was more than double that of 2012 (22 days). The court also questioned the Defendant's expert's reliance on BizMiner data broken out by annual sales from 2010 where the average DSO in 2012 for companies in the same sales class as Defendant was even shorter, averaging just 17.46 days. It was clear that industry members surveyed in 2012

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were not facing similar conditions as the members surveyed in the 2010 BizMiner report. Similarly, the court did not understand why the Defendant's expert relied on the RMA report, which covered only April 1, 2010 through March 30, 2011, and not 2012 when the Remaining Preference Payments were made. Significantly, there was an available RMA report (not relied upon by Defendant's expert) that covered the Preference Period and included an average DSO of 20 days, which supported the Debtors' position that the objective OCB defense did not apply.

Conclusion[2]

The AFA Investment decision is significant because it reaffirms prior Delaware bankruptcy court holdings that recognize paid new value as part of a creditor's new value defense to preference liability. The decision should also serve as a lesson to trade creditors that the subjective OCB defense is not satisfied solely based on a debtor's frequent late payments prior to the preference period. A court evaluating the applicability of the subjective OCB defense will still compare the extent of the

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lateness of the payments both prior to and during the preference period. Finally, trade creditors seeking to prove the objective OCB defense should make sure their expert relies on industry data close to the preference period.

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1. Other courts have considered practices in the debtor's industry or a combination of the debtor's and creditor's industries.
2. On March 24, 2016, the Defendant appealed the *AFA Investment* court's decision to the United States District Court in Delaware.

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