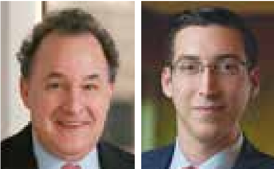
business
CREDIT
NOVEMBER/DECEMBER 2022
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $9.00

A Victory for the Trade:

Décor Holdings Decisions Uphold Applicability of Subjective Ordinary Course of Business Defense to Preference Liability



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A trade creditor dealing with a financially distressed customer faces not only the risk of nonpayment, but also the risk of preference liability if the customer ends up in bankruptcy. Fortunately, the Bankruptcy Code provides a number of defenses that a creditor can invoke to limit preference liability. One of the most prominent defenses is the subjective component of the ordinary course of business (OCB) defense, where a preference defendant can limit its preference liability by proving that the payments made during the 90 days before the bankruptcy filing (i.e., the "preference period") were consistent with the debtor's history of payments to the creditor before the preference period. Recent decisions by the United States Bankruptcy Court and District Court for the Eastern District of New York in the Chapter 11 cases of *Décor Holdings, Inc.* illustrate that there are various methodologies that creditors can assert, and courts can apply, to prove the subjective OCB defense.

Background on Preference Claims and Defenses

Pursuant to Section 547(b), a trustee (or debtor in possession) may, based on reasonable due diligence in the circumstances of the applicable case and taking into account a creditor's known or reasonably knowable affirmative defenses, avoid and recover a transfer as a preference by proving the following:

- The debtor transferred its property to or for the benefit of a creditor. The most frequent type of transfer is the debtor's payment from its bank account to a creditor [Section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered [Section 547(b)(2)];
- The transfer was made when the debtor was insolvent, which is based

on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period, [Section 547(b)(3)];

- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [Section 547(b)(5)].

Bankruptcy Code Section 547(c) provides creditors with multiple defenses to reduce preference exposure. These defenses are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed companies.

A frequently invoked defense to preference liability is the "ordinary course of business" defense under Section 547(c)(2).[1] To prevail on the OCB defense, a creditor must first prove that the alleged preference payment satisfied a debt incurred by the debtor in the ordinary course of business between the debtor and creditor. Creditors that sold goods or provided services to the debtor on credit terms usually have little trouble satisfying this element of the defense. Then, a creditor must prove that the preference payment was either: (A) made in the ordinary course of business or financial affairs between the debtor and creditor (frequently referred to as the "subjective" prong of the OCB defense), or (B) made according to ordinary business terms (frequently referred to as the "objective" prong of the OCB defense).[2]

The subjective component of the OCB defense was at issue in *Décor Holdings*. To satisfy the subjective OCB defense, a creditor must prove some consistency between the alleged preference payments and the payment history and relationship between the creditor and debtor. This defense usually requires a comparison of the timeliness and other characteristics of a debtor's payments to the creditor during the 90-day preference period with the payments made during some time period prior to the preference period (i.e., the "baseline period").[3]

The two most frequently used tests for comparing payments made during the preference period and baseline period are the "average lateness" method and the "total range" method. Under the average lateness method, the court compares the average number of days it took the debtor to pay invoices (from either the invoice date or the due date) during the baseline period with the average number of days it took the debtor to pay invoices (from either the invoice date or the due date) during the preference period. If those two averages are similar, then the subjective OCB defense would apply.

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Under the total range method, the court reviews all of the payments made during the baseline period to determine the range of days it took to pay each invoice (whether from the invoice date or due date) from fewest to greatest; if an alleged preference payment falls within that range, then it is protected by the subjective OCB defense. Some courts have further refined the baseline range by applying a modified range or "bucketing" analysis, which is intended to eliminate outlier payments from the total range. Courts relying on a bucketing analysis group the payments made during the baseline period into "buckets" by days-to-pay or days-late, and then compare them to the payments made during the preference period, which are grouped into similarly sized buckets.

In *Décor Holdings*, the United States Bankruptcy Court for the Eastern District of New York ("Bankruptcy Court") and the United States District Court for the Eastern District of New York ("District Court") made clear that the bankruptcy court has the sole discretion to determine which test or methodology to apply—and how to apply that test or methodology—when considering a creditor's subjective OCB defense.

Background Regarding the *Décor Holdings* Decision

On February 12, 2019, *Décor Holdings, Inc.* and its affiliated debtors (the "Debtors") filed voluntary petitions for relief with the Bankruptcy Court under Chapter 11 of the Bankruptcy Code. The Debtors thereafter filed a Chapter 11 plan of liquidation that was thereafter confirmed by the Bankruptcy Court by order entered on May 6, 2019. Pursuant to the plan, a litigation administrator (the "Plaintiff") was appointed for the purpose of pursing estate causes of action, including preference claims.

The Plaintiff filed adversary proceedings asserting preference claims against Bravo Fabrics, Swavelle/Mill Creek Fabrics, Inc., Rosenthal & Rosenthal, Inc., and P. Kaufmann, Inc. (collectively, the "Defendants"). On August 31, 2021, the Defendants filed motions for summary judgment asserting affirmative defenses based largely on the subjective OCB defense under section 547(c)(2) of the Bankruptcy Code.[4] The Plaintiff opposed the Defendants' summary judgment motions and filed cross-motions for summary judgment on its *prima facie* case regarding the preference claims in each adversary proceeding. At a hearing held on December 1, 2021, the Bankruptcy Court granted the Plaintiff's cross-motions for summary judgment on its respective *prima facie* cases. The Bankruptcy Court then directed that the parties file additional briefs addressing whether the subjective OCB defense should be applied to reduce or eliminate the Defendants' preference liability (and which test was appropriate to prove the defense).

The Defendants argued that the Bankruptcy Court should apply the average lateness test. The Defendants also argued that even if the court applied a total or modified range-based analysis, substantially all[5] of the preference payments were protected by the subjective OCB defense. On the other hand, the Plaintiff argued that the Bankruptcy Court should not rely on the total range method because there were

"wild variations" in the number of days it took the Debtors to pay each invoice during the Defendants' respective baseline periods that were not present during the preference period. Plaintiff sought to apply a bucketing analysis that groups the payments made during the baseline period into buckets based on the number of days late and then allocating the payments made during the preference period to similarly sized buckets to determine whether the payments made during the baseline and preference periods were consistent. According to the Plaintiff, the average lateness method painted an inaccurate picture because of the wide range of payments made during the baseline period. In support of its bucketing argument, the Plaintiff presented charts allegedly demonstrating that the pattern of payments made during the respective baseline periods was dissimilar to the pattern of payments made during the preference period.[6]

On February 3, 2022, the Bankruptcy Court held that substantially all of the alleged preference payments were protected by the subjective OCB defense. The Bankruptcy Court applied the average lateness method sought by Defendants, stating that it was more likely to "weed out" payments that could skew the analysis. The Court concluded that the Defendants proved the subjective OCB defense since the difference between the average lateness during the historical baseline period and the preference period was no more than seven days with respect to each Defendant.

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The Bankruptcy Court also concluded that Defendants could use a range-based methodology to support their subjective OCB defense. The Bankruptcy Court adopted a modified range analysis noting that a bucket including 82% of the payments made during the respective baseline periods in each case covered virtually all of the alleged preference payments. In so doing, the Bankruptcy Court rejected Plaintiff's bucketing analysis, noting that the percentage of payment ranges within any given bucket during the baseline period need not be identical to the percentage of payment ranges within the same bucket during the preference period.

On February 9, 2022, the Bankruptcy Court entered an order dismissing the Plaintiff's preference complaints, consistent with its opinion. The Plaintiff then appealed the Bankruptcy Court's order to the District Court.

In its appellate briefing, the Plaintiff argued that the Bankruptcy Court erred in relying on the average lateness method and in its application of a modified range bucketing analysis. Specifically, the Plaintiff argued that the bucket encompassing 80% of the baseline period payments ignored the lack of consistency in payments made during the baseline and preference periods. For example, 85% of the preference period payments were made in the bucket of 31 to 35 days late, while only 10% of the baseline period payments were made in that bucket. Further, the baseline payments were separated into 17 buckets while the preference period payments were separated into only five buckets. Additionally, 12 of the 17 baseline period buckets contained less than 10% of the baseline period payments.

The Defendants argued that the Bankruptcy Court had properly applied the average lateness method in the first instance and had also properly utilized a range-based bucketing analysis in holding that the Defendants had satisfied their respective subjective OCB defenses.

The District Court's Ruling

The District Court affirmed the Bankruptcy Court's ruling that each of the Defendants had satisfied the requirements of the subjective OCB defense. Noting that the Bankruptcy Court has the sole discretion to decide which test to apply, the District Court concluded that the Bankruptcy Court had "thoroughly examined" whether and correctly decided that it was appropriate to apply the average lateness test in determining the applicability of the subjective OCB defense. The District Court rejected the Plaintiff's argument that the average lateness test was inapplicable as a result of the outliers that allegedly skewed the analysis. The Bankruptcy Court considered the alleged outliers and nonetheless concluded they were "completely in character based on the parties' prior payment history." The District Court also agreed with the Bankruptcy Court's holding that the subjective OCB defense applied notwithstanding a difference of up to seven days between the average lateness during the preference period and during the baseline period. The District Court relied on other court decisions that had upheld creditors' subjective OCB defenses where the difference in average lateness during the preference and baseline periods ranged from five to 21 days.

The District Court also concluded that the Bankruptcy Court was correct in determining that the Defendants had satisfied the requirements of their subjective OCB defenses based on a range-based bucketing analysis. In so doing, the District Court rejected Plaintiff's attempt to create "artificially narrow buckets" by requiring consistency in the composition of baseline period and preference period buckets. The District Court concluded that the Bankruptcy Court had appropriately relied on a bucket range that captured at least 80% of the payments made during the baseline period. The District Court relied on other court holdings where the defendants had satisfied the subjective OCB defense based on similar ranges, including a 2016 decision by the U.S. Court of Appeals for the Seventh Circuit in the *Sparrer Sausage* case, that relied on a range that included 88% of the baseline period payments.

Conclusion

The *Décor Holdings* decisions should be embraced by trade creditors since they demonstrate the considerable amount of flexibility that courts have when analyzing the subjective OCB defense. The *Décor Holdings* decisions make crystal clear that a preference defendant can prove the subjective OCB defense by relying on an

average lateness analysis even where there is a wide range in the number of days the debtor took to pay each invoice during the baseline period. The decisions also benefit creditors by providing support for using a modified range-based bucketing analysis that includes at least 80% of the payments made during the baseline period to prove the subjective OCB defense. The courts' flexibility in analyzing the consistency of payments during the baseline and preference periods expands the circumstances in which a defendant can successfully prove its subjective OCB defense.

Ultimately, if nothing else, the *Décor Holdings* cases demonstrate that preference defendants should wield every tool in their preference defense toolkit to the greatest extent possible, particularly with respect to the subjective OCB defense. The bankruptcy court has a great deal of discretion in determining the applicability of the subjective OCB defense and, therefore, each case presents a creditor with an opportunity to persuade a bankruptcy court to apply the methodology that best suits the creditor under the circumstances.

1 Another frequently invoked preference defense, the "new subsequent value" defense under Section 547(c)(4), reduces a creditor's preference liability dollar-for-dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the creditor's receipt of an alleged preference payment. The new value defense was not addressed in the *Décor Holdings* decision.

2 A creditor proves the objective component of the OCB defense by presenting evidence that the alleged preference payments were consistent with payment practices and terms in the creditor's industry, the debtor's industry or a subset of both industries (e.g., suppliers like the creditor selling to buyers like the debtor). The objective OCB defense was also not addressed in the *Décor Holdings* decision.

3 In *Décor Holdings*, the Plaintiff and Defendants agreed that the baseline period was the two year period prior to the beginning of the preference period.

4 The Defendants also asserted other defenses. However, the *Décor Holdings* decisions primarily focused on the subjective OCB defense because, if successfully proven, the subjective OCB defense alone was sufficient to insulate virtually all of the alleged preference payments from liability.

5 The Defendants argued that the subjective OCB defense covered all but one payment made to one of the Defendants, in the amount of only $1,937.03. The Bankruptcy Court held that this nominal payment was covered by other defense(s).

6 The Plaintiff acknowledged that: (i) the Debtors ordinarily paid the Defendants beyond the stated terms of the applicable invoice, (ii) every payment during the preference period was made by check (as were the payments during the pre-preference baseline period), (iii) the Debtors never informed the Defendants of any financial troubles suffered by the Debtors, and (iv) there was no unusual collection activity or payment pressure during the preference period.

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