Another Win for the Trade on the Subjective Ordinary Course of Business Preference Defense Despite Persistent Requests for Payment


Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy & Restructuring Department, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the former co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is counsel in Lowenstein Sandler's Bankruptcy & Restructuring Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

Preference claims are a trade creditor's worst nightmare. It's bad enough to be left with a potentially uncollectable claim against a bankrupt customer; it's insult to injury to also have to turn over payments received from the customer in the 90 days before its bankruptcy. Fortunately, creditors can assert defenses to preference claims, including the ordinary course of business, or OCB, defense. While increased collection efforts may negate a creditor's OCB defense, the Delaware bankruptcy court in *re Diversified Mercury Communications, LLC* recently held that a creditor satisfied the OCB defense even though it had persistently sent several email requests to collect its claim!

What Is a Preference?

A debtor or trustee in bankruptcy can seek to recover payments made to creditors before the bankruptcy filing as a "preference" by proving the following:

1. A transfer of property of the debtor's estate (such as a debtor's payment);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (such as an outstanding invoice);
4. On or within the 90 days before the bankruptcy filing;
5. Made when the debtor was balance sheet insolvent (there is a rebuttable presumption of insolvency within the 90-day period);

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6. That enables the creditor to receive more than it would in a hypothetical Chapter 7 bankruptcy case.

The legislative purpose of the preference statute is to treat creditors fairly by redistributing prepetition payments to "preferred" creditors among all similarly-classified creditors. But "fairness" is in the eye of the beholder—creditors facing preference risk find this process unfair!

What Is the OCB Defense?

There are multiple preference defenses that creditors can wield. These defenses are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed companies.

The OCB defense is one of the most prominent preference defenses. A creditor proves the OCB defense by demonstrating that:

1. The preference payment satisfied a debt incurred by the debtor in the

ordinary course of business between the parties, and

2. The payment was made either:
   (A) in the ordinary course of business or financial affairs between the parties (the "subjective" prong of the OCB defense), *or*
   (B) according to ordinary business terms (the "objective" prong of the OCB defense).[1]

The *Diversified Mercury* decision focused on the subjective OCB defense. Creditors prove this defense by showing consistency in the timing and manner of the debtor's payments during, and before, the 90-day preference period. However, even if there is consistency in the payment activity during these two periods, a court may reject a creditor's subjective OCB defense if the creditor had applied "collection pressure" on the debtor during the preference period, by:

- Restricting or otherwise changing credit terms
- Imposing or enforcing credit limits
- Threatening to stop shipment
- Imposing credit holds
- Changing invoice method (e.g., electronic vs. paper)
- Pressing a debtor to change its
  - Payment method (regular check to wire, ACH, etc.)
  - Delivery method (regular mail to Federal Express or hand delivery)

What Happened in the *Diversified Mercury* Case?

On Apr. 3, 2019, an involuntary Chapter 7 petition was filed against Diversified Mercury Communications, LLC in the Delaware bankruptcy court. On May 23, 2019, Diversified Mercury's affiliate, DTR Advertising, Inc., filed a voluntary Chapter 7 petition in the same court. The two cases were jointly administered, and a Chapter 7 Trustee was appointed to liquidate the debtors' assets and pursue potential sources of recovery (such as preference claims).

Dating back to August 2015, the debtors had conducted business with Direct Results Radio, Inc. under a "client share agreement." Direct Results negotiated with radio, streaming, and satellite broadcasters to place advertisements for one of the debtors' clients. In exchange, the debtors reimbursed Direct Results' expenses and paid Direct Results 50% of the commissions the debtors had received from the client.

Historically, Direct Results reconciled all of the relevant invoices from broadcasters each month, and then issued one invoice to the debtors for the monthly amount owed to the broadcasters, plus Direct Results'

The Bankruptcy Court's Ruling

The Bankruptcy Court ruled in favor of Direct Results, concluding its subjective OCB defense carried the day. In doing so, the Court considered the following:

- **Duration of the parties' course of dealing** – the Bankruptcy Court concluded there was a sufficient period of time to establish an ordinary course of dealing between the parties, since there were 20 transactions between them during the two years before the preference period.

- **Timing of payments** – prior to the preference period, Direct Results received payments from the debtors between 28 and 74 days after an invoice was sent to the debtors, an average of approximately 46 days-to-pay. This was consistent with Direct Results' receipt of the debtors' check on Dec. 3, 2018 (49 days from the date the August invoice was sent).

  - The Bankruptcy Court rejected the Trustee's argument that the days-to-pay the August invoice was much greater, based on either (i) the number of days between the invoice date (Aug. 26, 2018) and the date the check cleared (Jan. 3, 2019)—130 days-to-pay, or (ii) the number of days between the date the check was sent (Oct. 15, 2018) and the date the check cleared—76 days-to-pay. The Bankruptcy Court held that (a) the invoice date was irrelevant, since Direct Results had previously sent invoices well after the actual invoice date, and (b) the check's clearance date was also irrelevant, since the parties had previously determined the timeliness of payments based on the date payments were sent/received and Direct Results determined the timing of depositing any check.

  - Interestingly, Direct Results' delay in depositing the check did not impact its subjective OCB defense, even though the delay is what caused the payment to fall within the preference period and gave rise to the preference claim.

- **Unusual collection efforts and advantages in light of the debtors' financial condition** – The Bankruptcy Court held these factors weighed in Direct Results' favor. Though Direct Results emailed the debtors regarding past-due invoices, the emails "were polite inquiries regarding the status of payment, and follow-up emails were consistent with Direct Results' past practice when confronted with late client payments." Also, the evidence suggested the need for timely payment was motivated by Direct Results' desire to pay third party broadcasters rather than fear of the debtors' inability to pay. There was no evidence that Direct Results had known about the debtors' deteriorating financial condition (if they had, they surely wouldn't have waited to deposit the check and run the risk that it would clear during a preference period or, worse, wouldn't clear at all!).

  - The Trustee also argued that the timing of payment between the collection emails and the wire transfer on account of the September invoice showed successful payment pressure that rebutted the subjective OCB defense. However, the Bankruptcy Court held that alleged payment pressure was irrelevant, since the payment for the September invoice was outside the preference period.

commission. This process typically took 45 days. Direct Results would then email an invoice to the debtors, with payment due in 30 days. Direct Results ultimately paid the broadcasters with the payment received from the debtors.

During the historical period before the preference period, the debtors made 20 payments to Direct Results. Most of the payments were by check, and all were received between 28 to 74 days after the applicable invoice was sent—an average of 46 days-to-pay. All checks cleared within a week of receipt by Direct Results prior to the preference period.

The debtors became financially distressed before the fall of 2018, though there was no evidence that Direct Results was aware of this. Consistent with historical practices, on Oct. 15, 2018, Direct Results emailed the debtors an invoice for August advertisements in the amount of approximately $500,000, dated Aug. 26, 2018, and due on Nov. 15, 2018. On Nov. 13, Direct Results emailed the debtors an invoice for September advertisements in the amount of approximately $665,000, which was due on Dec. 14, 2018.

The debtors failed to timely pay the August invoice, prompting Direct Results' bookkeeper to email the debtors' accounts payable representative, consistent with the parties' historical practices. When that email went unanswered, the bookkeeper sent a follow up email on Nov. 26, 2018 to the debtors' accounts payable representative, saying: "I hope you had a good Thanksgiving! Do you have an update on the below [email regarding payment]?" The bookkeeper also simultaneously sent an email to one of the debtors' account managers, asking whether the accounts payable representative was available. The debtors did not respond to either email.

On Nov. 27, an account director of Direct Results sent an email to a senior director of the debtors, asking for "help" in collecting the August invoice since the debtors had been unresponsive. The debtors responded the next day indicating that payment was scheduled for Nov. 30. The bookkeeper responded on Nov. 29, this time copying the debtors' president and senior account director, stating that the debtors needed to "speed up" their payments so Direct Results could timely pay advertisers.

On Dec. 3, Direct Results received a check for $493,349.34 from Diversified Mercury for the August invoice (at which point, Direct Results' bookkeeper followed up again on the September invoice, which was thereafter paid by wire on Dec. 28, 2018). However, Direct Results delayed depositing the check until Jan. 2, 2019, for "financial management and tax purposes." As a result, the check cleared on Jan. 3, 2019, 90 days before the involuntary bankruptcy filing against Diversified Mercury.

On Mar. 18, 2021, the Trustee filed a complaint to recover Diversified Mercury's payment of $493,349.34 to Direct Results for the August invoice. Direct Results asserted the subjective OCB defense, and other defenses, in an answer filed on July 12, 2021. The parties engaged in discovery and pretrial briefing, and the Bankruptcy Court conducted a trial on Nov. 9, 2022.

Conclusion

The *Diversified Mercury* decision is a huge win for the trade. The decision indicates that escalated collection pressure, like persistently sending inquiries about past-due invoices, may not impact a subjective OCB defense if the collection pressure was consistent with prior practice or only prompted payments that were not included in the preference claim. Regardless, when dealing with a financially distressed customer, creditors should always be mindful of the potential adverse implications of their collection efforts on the availability of the subjective OCB defense.

1 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).