A Little More You Need to Know About the "Ordinary Course of Business" and "New Value" Preference Defenses

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Abstract:

This article discusses recent court decisions that have further developed the law regarding the application of the ordinary course of business and new value preference defenses. The article is intended to update two previously published articles: Everything You Need To Know About The "Ordinary Course of Business" Preference Defense, And More! published in Volume 19, Number 1, 1st Quarter 2013 and Everything You Need to Know About New Value as a Preference Defense, and More published in Volume 17, Number 2, 2nd Quarter 2011.

What is a Preference?

According to section 547(b) of the Bankruptcy Code, a trustee can avoid and recover a transfer as a preference by proving all of the following elements of a preference claim:

i. The debtor transferred its property (usually by tendering payment) to or for the benefit of a creditor. [section 547(b)(1)];

ii. The transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor. [section 547(b)(2)];

iii. The transfer was made when the debtor was insolvent based on a balance sheet definition of insolvency - liabilities exceeding assets [section 547(b)(3)]. The debtor's insolvency within the 90-day period prior to its bankruptcy filing is presumed, making it easier for a trustee to prove. The creditor has the burden to present some evidence of the debtor's solvency to rebut this presumption. Once rebutted, the burden shifts back to the trustee to prove the debtor's insolvency;

iv. The transfer was made within 90 days of the debtor's bankruptcy filing, in the case of a transfer to a non-insider creditor, and within one year of the bankruptcy filing for a transfer to an insider of the debtor, such as the debtor's officers, directors, controlling shareholders and affiliated companies. [section 547(b)(4)]; and

v. 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)]. This requirement is easy to satisfy unless the recipient of the alleged preference can prove that it was fully secured by the debtor's assets, was paid from the proceeds of its collateral, or all creditors' claims were (or will be) paid in full.

Once a trustee proves all of the elements of a preference claim under section 547(b), the creditor has the burden of proving one or more of the affirmative defenses to a preference claim contained in section 547(c) of the Bankruptcy Code to reduce or eliminate its preference exposure. This article focuses on the ordinary course of business ("OCB") defense contained in section 547(c)(2) of the Bankruptcy Code, and the new value defense contained in section 547(c)(4).

I. THE ORDINARY COURSE OF BUSINESS DEFENSE

The OCB defense requires proof, by a preponderance of the evidence that (1) the alleged preferential transfer paid a debt that was *incurred* in the ordinary course of the debtor's and creditor's business or financial affairs—which merely requires proof of a trade creditor's extension of credit terms to the debtor—and (2) that the transfer was *either* (a) made in the ordinary course of the debtor's and creditor's business or financial affairs (the "subjective" part of the OCB defense), or (b) made according to ordinary business terms (the "objective" part of the OCB defense).

The OCB defense is intended to encourage the continuation of business with (and the extension of credit to) an entity that is sliding into, but seeking to avoid, a bankruptcy filing. The OCB defense is supposed to protect from preference risk a debtor's payment to a creditor during the 90-day period prior to the debtor's bankruptcy filing (the "preference period") that was made in a consistent manner with either the parties' history or how payments are made in the applicable industry. Nevertheless, the courts have been inconsistent and unpredictable in the manner in which they have applied the OCB defense, resulting in expensive litigation over this defense.

A. The Subjective Element of the Ordinary Course of Business Defense

A creditor relying on the subjective prong of the OCB defense must first demonstrate a pre-preference period payment history or "baseline of dealing" between the debtor and the creditor and then compare that to the alleged preferential transfers. As part of this analysis, the court usually considers the following factors: (i) the length of time the parties were engaged in the type of dealing at issue; (ii) whether the amounts of the alleged preferential transfers were larger than prior payments; (iii) whether the payments were tendered in a manner different from previous payments; (iv) whether there was any unusual action by either the debtor or the creditor to collect or pay the debt; and (v) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition.

There are frequently two components of a court's determination of whether the subjective part of the OCB defense protects the alleged preferential transfers: (i) a statistical analysis primarily focused on comparing the timing of the historical and alleged preferential transfers, and (ii) a determination of whether the factual circumstances surrounding the alleged preferential transfers were unusual. The latter determination considers the extent of any collection efforts and other pressure the creditor had exerted to obtain payment of the alleged preferential transfers. These components of the court's analysis do not carry equal weight as the OCB defense may be inapplicable where an otherwise preferential transfer was made in response to payment and other collection pressure, even where there is a consistency in the timing of the payment based on a statistical analysis.

The Statistical Analysis

Many courts considering the applicability of the subjective prong of the OCB defense have considered whether the alleged preferential transfers, based on timing of the transfers or otherwise, were consistent with the parties' prior course of dealing. The courts have undertaken various forms of statistical analyses and approaches in considering the applicability of the subjective OCB defense. For example, the courts have compared the timing of the payments made during and prior to the preference period based on (i) average (straight or weighted), (ii) median, (iii) deviation off of an average or median, (iv) range (or ranges), (v) regularity of payments based on percentages, or (vi) a combination of one or more of the above methodologies.

Pre-preference Period – How Long is Long Enough?

A bankruptcy court considering a historical baseline of dealings between the parties usually first considers the parties' payment history prior to the preference period. As discussed in the 2013 article, the courts have disagreed on the length of time to be considered in determining the historical baseline course of dealing between the parties. Recent decisions have approved a two year historical period.

In *Davis v. R.A. Brooks Trucking, Co., Inc. (In re Quebecor World (USA))*, the United States Bankruptcy Court for the Southern District of New York relied on a two-year historical period asserted by the plaintiff, rather than a one-year historical period asserted by the defendant. The court held that the longer two year historical period more accurately reflected the parties' ordinary course of dealings because it included the period when the debtor was in better financial health. This contrasted with the one year period the defendant had asserted when the debtor was financially distressed.

Similarly, in *Cox v. Momar Inc.* (*In re Affiliated Foods Sw. Inc.)*, the bankruptcy trustee argued that a one year period prior to the preference period was appropriate when comparing the timing of payment prior to and during the preference period. The United States Court of Appeals for the Seventh Circuit disagreed, holding that a two year historical baseline provided a more accurate picture of the parties' ordinary course of dealing. The court explained that in order to properly evaluate payments made during the preference period, the payment history should be based on a timeframe when the debtor was financially healthy. The court also justified the use of a two year payment history by the fact that there were only nine transactions during the two years prior to the bankruptcy filing, and only three transactions during the one year prior to the preference period when the debtor was in financial distress. This court suggested that a one year payment history might have been appropriate if there were hundreds of payments during the year prior to the preference period.

May the Court Exclude Portions of the Pre-preference Period When the Debtor was in Distress?

Recently, several courts have limited the historical baseline to when the debtor was financially healthy. There was ample precedent for this based on *Siegel v. Russellville Steel Company, Inc. (In re Circuit City Stores, Inc.)*, where the United States Bankruptcy Court for the Eastern District of Virginia excluded from the payment history the approximately nine month period immediately prior to the preference period, when the debtor was in financial distress. The court instead relied solely on the prior history when the debtor was healthy.

More recently, in *The Unsecured Creditors Committee of Sparrer Sausage Company, Inc. v. Jason's Foods, Inc. (In re Sparrer Sausage Co.)*, the relationship between the debtor, Sparer, and the defendant began on February 2, 2010 and continued until Sparrer's bankruptcy filing on February 7, 2012. The United States Court of Appeals for the Seventh Circuit upheld the bankruptcy court's finding that only payments made during the portion of the parties' historical relationship when Sparrer was financially healthy—February 2, 2010 to April 15, 2011—were the appropriate historical baseline to compare to the alleged preference payments. The court considered the period when Sparer was financially healthy, instead of when Sparer was in financial distress, as a better reflection of the parties' typical payment practices.

Similarly, in *Goodman v. Candy Fleet, LLC (In re Gulf Fleet Holdings, Inc.)*, the United States Bankruptcy Court for the Western District of Louisiana also limited the historical baseline period to when Gulf Fleet, the debtor, was adequately capitalized. The court rejected the defendant's proposed historical baseline—January 1, 2008 through April 30, 2009—as an appropriate baseline. First, the defendant's proposed historical baseline ignored the fact that Gulf Fleet's financial condition began deteriorating in 2009, which was reflected in the parties' payment history. Second, the defendant's proposed historical baseline ignored the impact of a cash infusion that Gulf Fleet's owner had provided in February 2010, which allowed Gulf Fleet to pay invoices more quickly during the preference period. Accordingly, the court held that the parties' payment history in 2008—when Gulf Fleet was financially healthy—was a sound historical baseline against which to compare the payments made during the preference period.

No Pre-preference Period Payment History

The courts have reached conflicting holdings over whether the subjective OCB defense can protect a payment made during the preference period if there was no pre-preference period history between the parties; *i.e.* the alleged preferential payment was the debtor's first payment to the defendant, or there was a very limited history of dealings between the parties.

In *Jubber v. SMC Electrical Products, Inc., et al. (In re C.W. Mining Co.)*, the United States Court of Appeals for the Tenth Circuit applied the subjective OCB defense to a first time transaction between the debtor and a defendant during the preference period. The debtor, C.W. Mining, a coal-mining company, entered into a contract with the defendant to purchase certain equipment in order to convert its mining method to a "longwall system," with payments under the contract due in installments. The parties did not do business prior to this contract. During the 90-day preference period, the debtor made an installment payment of $200,000 that was received two days prior to the invoice due date. When sued for the return of the payment as a preference, the defendant asserted the subjective OCB defense, even though the defendant had no prior dealings with the debtor.

The Tenth Circuit held that a first-time transaction would be protected by the subjective OCB defense as long as it is "ordinary in relation to this debtor's and this creditor's past practices when dealing with other, similarly situated parties." The court concluded that C.W. Mining both incurred the debt and made the $200,000 payment to the defendant in the ordinary course of business and was, thus, protected by the subjective prong of the OCB defense. The purchase was an arms-length transaction between the parties and the purpose of the purchase was to assist in mining operations. In addition, C.W. Mining had paid the defendant from its own bank account just two days prior to the invoice due date, and there was no evidence of any collection activity by the defendant.

Consistency of, and Method to Determine, Timing of Payments During the Historical Period and the Preference Period

Most court decisions dealing with the applicability of the subjective prong of the OCB defense have relied on the consistency in the timing of the alleged preference payments compared with the timing of payments during the parties' prior course of dealing before the preference period. The courts have compared the timing of the payments made during and prior to the preference period based on a variety of methodologies that have sometimes led to conflicting decisions.

In *Quebecor*, nearly all of the payments made during the preference period were not protected by the subjective OCB defense. The court relied on two methodologies: the average lateness method which considered the average time of payment after issuance of an invoice prior to and during the preference period and plaintiff's "bucketing analysis" which grouped the debtor's historical payments by age. The court relied on the significant disparity of 29.6 days between the average days to pay of 27.56 prior to the preference period and 57.16 during the preference period. The court also relied on the fact that 88% of the debtor's payments prior to the preference period, paid invoices between 11 and 40 days after receipt of the invoice, compared to only 22% of the payments during the preference period.

The court rejected the "total range method" that defendant asserted as the appropriate methodology, which considers as ordinary any preference payment falling within the minimum and maximum days to pay during the historical period. The court found that this method improperly captured outlying payments and skewed the analysis of what is ordinary.

Bottom line: the court concluded only payments up to 45 days after invoice date were sufficiently consistent with a historical baseline of 93% of the debtor's payments to the defendants prior to the preference period to be considered subjectively ordinary. That excluded nearly all of the alleged preference payments which were, therefore, not protected by the subjective OCB defense.

In *In re Sparrer Sausage Co.*, the bankruptcy court relied on an OCB range of 16 to 28 days after invoice date in evaluating whether the alleged preference payments satisfied the subjective element of the OCB. The court determined the average invoice age of 22 days to pay during the historical period, then added 6 days on both sides of that average and concluded that only payments of invoices 16 to 28 days after invoice date satisfied the subjective OCB defense. Of the 23 invoices paid during the preference period, 12 were paid within the 16 to 28 day range and 11 others were paid outside that range. The debtor's payment of 11 invoices paid 14, 29, 31, 37, and 38 days after invoice date did not satisfy the subjective OCB defense and were avoidable as preferences. The defendant then appealed to the United States District Court, which affirmed the bankruptcy court's ruling.

On appeal, the Seventh Circuit held that the bankruptcy court should not have used a historical baseline range of 16 to 28 days after the invoice date to analyze the subjective prong of the OCB defense. The court found that range to be excessively narrow and arbitrary because it encompassed only 64% of the payments Sparrer had made to the defendant during the historical period. If the range were expanded by just two days on each end to 14 to 30 days to encompass 88% of the payments made during the historical period, all but two payments, made 37 and 38 days after the invoice date, would have been protected by the defense. Defendant ended up having no preference liability because the two payments were fully offset by the new-value defense.

In *In re Affiliated Foods Sw. Inc*., the Eighth Circuit appeared to be applying the total range and average methodologies in evaluating the applicability of the subjective OCB defense. The court relied on a historical average days to pay of approximately 35 days between invoice and payment date, resulting in a range of 13 to 49 days between invoice and payment date. The court ruled that the alleged preferential payment at issue, which was made 26 days after the invoice date, fell within the historical baseline and, therefore, was protected by the subjective prong of the OCB defense.

In *Burtch v. Revchem Composites, Inc. (In re Sierra Concrete Design, Inc.)*, the bankruptcy court held that the subjective OCB defense applied even though the alleged preference payments were made much faster than prior payments. The parties had operated under an agreement that included payment terms and a credit limit for the debtors. When the debtors were at or near the credit limit, Revchem required the debtors to pay previously issued invoices before Revchem shipped new product.

Prior to the 90-day preference period, from February 2004 through April 2008, the debtors' average days-to-pay from the invoice date was 55.22 days, with a range of 0 to 116 days. During the preference period, the debtors' average days-to-pay was 27.3 days, with a range of 13 to 61 days. The court recognized the significance of the debtors' faster payments during the preference period in light of the 27.9 day difference between the 55.22 average days-to-pay prior to the preference period and the 27.3 average days-to-pay during the preference period. According to Revchem, the payments accelerated because the debtors needed product faster for a construction project with tight deadlines.

As a result, the court rejected the trustee's argument that the debtors' faster payments during the preference period precluded Revchem from satisfying the subjective OCB defense. The court also rejected the trustee's argument that the debtors' faster payment to Revchem during the preference period amounted to a material change in practice between the parties.[1] Revchem did not pressure the Debtors to pay outstanding invoices faster than usual during the preference period. Revchem was not aware of the debtors' financial problems and deteriorating financial condition. There was also no proof that the amounts paid during the preference period were larger than the payments prior to the preference period or that the debtors were paying in a different manner. Finally, although Revchem had imposed a credit limit on the debtors, that was the only way Revchem could make sure that the debtors were paying invoices in a timely manner. Moreover, the same credit limit was in effect during the year prior to the preference period and the parties had a history of working under a credit limit. Indeed, Revchem had not placed any credit holds with respect to shipments to the Debtors either prior to or during the preference period. As a result, the court found that the debtors' faster payments during the preference period to remain within the credit limit were consistent with the parties' prior business dealings and, therefore, should be shielded from preference liability by the subjective OCB defense.

In *Stanziale v. Industrial Specialists Inc., a/k/a Industrial Specialists, LLC* (*In re Conex Holdings, LLC)*, the United States Bankruptcy Court for the District of Delaware granted summary judgment (without a trial) in favor of the defendant based on the subjective OCB defense on the grounds that the timing of seven payments made during the preference period was consistent with the parties' pre-preference period history, despite small differences in timing during the pre-preference period. Prior to the preference period, the average days to pay was 61 days when including two outlier payments and 56 days when excluding the outliers. During the preference period, the average days to pay was 54 days. The court held that the differences in

[1]The inconsistent outcomes in *Sierra Concrete* and *Quebecor* clearly demonstrate the difficulty in predicting whether a court will apply the subjective OCB defense. In *Sierra Concrete*, the court applied the subjective OCB defense despite a 27.9 day disparity between the historical and preference period averages, whereas the *Quebecor* court refused to apply the subjective OCB defense in light of a similar 29.6 day disparity.

timing between the historical and preference periods—either a two day difference in average days to pay when excluding outlier payments prior to the preference period or a seven day difference in average days to pay when including the outlier payments—were not sufficiently problematic to take the alleged preferential payments outside of the parties' normal course of dealings.

The court also rejected the plaintiff's argument that certain payments should be omitted from the analysis because they were made to a different entity. The court concluded that the defendant had submitted undisputed proof that both the defendant and the other entity were the same. The court also took into account the consistency in the amount of the payments, the manner in which they were tendered prior to and during the preference period and the absence of unusual collection or other action by the defendant in response to the debtor's deteriorating financial condition.

Finally, in *In re AFA Investment Inc., et al., v. Dale T. Smith & Sons Meat Packing Company (In re AFA Investment Inc.)*, the United States Bankruptcy Court for the District of Delaware held that certain payments were not protected by the subjective OCB defense because of an inconsistency in the timing of payment of invoices prior to and during the preference period. During the approximately one year period prior to the preference period, 97% of all invoices were paid between 16–30 days after the invoice date. By contrast, during the preference period, 96% of the payments were made after 30 days. In addition, of the approximately $13 million in payments prior to the preference period, none were paid later than 35 days after the invoice date, while during the preference period, 71.7% of all invoices were paid after 35 days. Moreover, the weighted average days to pay nearly doubled from 22.43 days prior to the preference period to 43.95 days during the preference period. The court found these differences too significant, and therefore refused to apply the subjective OCB defense.

Change in Ownership

In *Satija v. C-T Plaster, Inc., aka Cen-Tex Plaster, Inc., et al. (In re Sterry Industries, Inc.),* the United States Bankruptcy Court for the Western District of Texas court analyzed the subjective OCB defense by a defendant whose ownership, and course of dealing, had changed prior to the preference period. Sterry and the defendant had a business relationship for some time prior to Sterry's bankruptcy filing. Up until six months before Sterry's bankruptcy, each invoice was on "Net 30" terms. Sterry would generally mail a check to the defendant but sometimes a representative of the defendant picked up the check.

Then, about six months prior to Sterry's bankruptcy filing, the defendant's business was sold to a new owner. From then on, the invoices stated that payment was "Due Upon Receipt," but witnesses testified that payments were really still due within 30 days. Also, the defendant's representative began picking up each check.

The bankruptcy court recognized that these changes altered the course of business between the parties, when compared to their course of dealings before the company was sold. Indeed, prior to the defendant's change in ownership, with few exceptions, Sterry had made payments between 53 and 112 days after the invoice date. After the ownership change, during the three months prior to the preference period, Sterry began paying faster, making timely payments (i.e. within 30 days) to the defendant.

Although Sterry and the new owners had only a three-month relationship with the defendant prior to the preference period, the court found that period was the relevant baseline to compare to the preference period because "with that [ownership] change came an agreed change in the business relationship between the two entities . . ." The court held that the subjective OCB defense protected the payments during the preference period because the timing and manner of payment (picking up the checks in person within 30 days) between Sterry and the defendant during the three months prior to the preference period was substantially the same as during the preference period. The court rejected the trustee's argument that the change on the invoices to read "Due Upon Receipt" instead of "Net 30" took the payments out of the ordinary course because witnesses had testified that the parties' payment terms remained the same—invoices were due within 30 days. The court also found that the defendant's practice of having a representative pick up the checks was not a coercive practice that took the payments out of the ordinary course of business because that practice began with the ownership change three months prior to the preference period and continued through the preference period. More tellingly for the court, the defendant did not act in a coercive manner where collections had actually slowed down slightly during the preference period (though defendant's invoices were still paid within 30 days).

The court was quite liberal in applying the subjective OCB defense to these facts. Another court might have reached the opposite conclusion and refused to apply the defense.

B. <u>The Objective Element of the Ordinary Course of Business Defense</u>

Even where a creditor cannot satisfy the subjective part of the OCB defense to shield a transfer from preference risk, the creditor would still be protected by satisfying the objective prong of the defense. A creditor seeking to invoke the protection of the objective OCB defense must prove that the payment or other transfer was made according to "ordinary business terms." The Bankruptcy Code does not define the phrase "ordinary business terms". The courts have determined that a creditor satisfies this requirement by proving that the transfer was consistent with payments made in the creditor's industry, the debtor's industry or some combination of both industries.

After determining the proper industry, creditors have relied upon numerous sources of data to establish a baseline against which transfers should be measured when determining if they were made according to "ordinary business terms." The sources of data include, among others, statistics from the Credit Research Foundation ("CRF"), Standard & Poors (Capital IQ) ("Capital IQ"), Dun & Bradstreet ("D&B"), the Risk Management Association ("RMA"), CreditRiskMonitor ("CRM"), and BizMiner. These sources aggregate data reported by companies in numerous industries during specific time periods, including data concerning the timing of the collection of receivables – oftentimes referred to as days sales outstanding ("DSO"). In addition, creditors have sought to prove ordinary business terms with varying degrees of success by relying on testimony from individuals with significant experience in the applicable industry.

Whose Industry Should be Relied Upon to Prove Ordinary Business Terms?

There have not been many published decisions addressing the industry a creditor can rely on in attempting to prove the alleged preference payments were made according to ordinary business terms. Nonetheless, this issue has been consistently raised by both plaintiffs and defendants over the last few years and has introduced another layer of complexity into determining the applicability of the objective OCB defense.

The United States Sixth Circuit Court of Appeals, in *First Federal of Michigan v. Barrow*, was one of the first Courts of Appeals to address this question. The court held that the ordinary business terms analysis was based on the debtor's industry. A few years later, the Sixth Circuit reiterated this view in *Logan v. Basic Distribution Co. (In re Fred Hawes Organization, Inc.)*, rejecting the argument that a creditor's interactions with its own customers could be relied upon in proving ordinary business terms. Instead, relying in part on *First Federal*, the court considered the debtor's industry as a whole. The Bankruptcy Appellate Panel of the Eighth Circuit in *Shodeen v. Airline Software, Inc. (In re Accessair, Inc.)* also held that only the debtor's industry was relevant in determining ordinary business terms.

By contrast, the Seventh Circuit, in the seminal decision addressing the meaning of "ordinary business terms", *In re Tolona Pizza Products Co.*, held that the courts should focus on the creditor's industry. However, the court recognized the difficulties in identifying the industry, as follows:

> Not only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry. Apparently there is in this industry, whatever exactly "this industry" is; for while it is plain that neither [creditor] nor its competitors enforce payment within seven days, it is unclear that there is a standard outer limit of forbearance. …. The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market.

Accordingly, the Court in *Tolona Pizza* held:

> "[O]rdinary 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. … There is no single set of terms on which the members of the industry have coalesced; instead there is a broad range and the district judge plausibly situated the dealings between [creditor] and [debtor] within it."

Relying on *Tolona Pizza*, the United States Court of Appeals for the Third Circuit, in *Fiber Lite Corp. v Molded Acoustical Products, Inc. (In re Molded Acoustical Products, Inc.)* also held that "ordinary business terms" should be analyzed with reference to the creditor's industry.[2] The Third Circuit used the same description of "ordinary business terms" that the court used in *Tolona Pizza* but added that the longer the creditor's pre-bankruptcy relationship with the debtor, the more the creditor could vary its credit terms from the industry norm and yet still satisfy the objective OCB defense. Likewise, the Fourth Circuit in *Advo-System, Inc. v. Maxway Corp*. held that "ordinary business terms" refers to the creditor's industry.

The Fifth Circuit in *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co. (In re Gulf City Seafoods, Inc.)*, took a slightly different approach and held that a combination of the debtor's and creditor's industries should be considered in proving ordinary business terms. The Fifth Circuit observed:

> Defining the industry whose standard should be used for comparison is not always a simple task…. In our view, for an industry standard to be useful as a rough benchmark, the creditor should provide evidence of credit arrangements of other debtors and creditors in a similar market, preferably both geographic and product. We think that the industry benchmark inquiry is best illustrated by application: In this case, [creditor] might provide evidence, to the extent that it is reasonably available, of credit practices between suppliers to whom [debtor] might reasonably turn for its seafood supply and firms with whom [debtor] competes for consumers, from which a bankruptcy judge can determine whether there is some basis to find that the [creditor-debtor] arrangement is not a virtual stranger in the industry.

More recently, the United States Bankruptcy Court for the Eastern District of North Carolina, in *Hutson v. Branch Banking & Trust Company (In re National Gas Distributors, LLC)*, articulated a more stringent standard for satisfying the objective prong of the OCB defense. The court held that a creditor seeking to prove the objective OCB defense must show that the transfers in question conformed with the ordinary business terms of <u>both</u> the debtor's and creditor's industries, and to "general business standards that are common to all business transactions in all industries."

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[2] Relying on the Third Circuit's decision in *Molded Acoustical*, the Bankruptcy Court for the District of Delaware in *AFA Investment Inc.* also recently held that the creditor's industry is the appropriate industry for proving ordinary business terms.

Do "Ordinary Business Terms" Include Only Payment Terms or Other Creditor Conduct?

Another issue that has recently been raised is whether "ordinary business terms" refer to only payment terms, or also encompass the entirety of a creditor's collection practices, including terms changes, pressure, shipping holds, threats or other similar conduct. While it is uncontroverted that pressure in collecting a creditor's claim can negate the applicability of the subjective prong of the OCB defense, it is unsettled, whether creditor pressure has the same negative impact on the applicability of the objective OCB defense.

There is nothing in the text of the Section 547(c) objective OCB defense that limits the "industry" test to a creditor's course of dealing with the debtor. Plaintiffs have argued that "ordinary business terms" encompasses all aspects of a vendor's collection practices. According to this argument, creditors should not be <u>rewarded</u> for the pressure they have exerted in collecting their claims just because the payments happened to have been made within the relevant industry OCB range.

There is limited case law addressing this issue. In *Simon v. Gerdau MacSteel, Inc. (In re American Camshaft Specialties, Inc.)*, the United States Bankruptcy Court for the Eastern District of Michigan held that the alleged preferential transfer at issue satisfied the subjective OCB defense despite the fact that there was a change in the method of payment (check to wire), the debtor's line of credit was reduced, and the defendant refused to ship product. In addressing the objective OCB prong, the court also noted that the applicability of the objective OCB defense is not affected by a creditor pressuring the debtor into making the payments by wire transfer.

Similarly, the United States Bankruptcy Court for the Southern District of New York in *Pereira v. United Parcel Service of America, Inc. a/k/a UPS, et al. (In re Waterford Wedgwood, USA, Inc.)* held that a significant deviation in the average days-to-pay during the pre-preference period did not impact a creditor's ability to invoke the objective OCB defense. United Parcel Service of America Inc. ("UPS") had provided shipping and other related services to the Waterford Wedgwood USA, Inc. and Royal Doulton USA, Inc. (collectively, the "Waterford Debtors"). The Waterford Debtors consistently paid UPS's invoices later than the "net 32 day" payment terms both prior to and during the preference period.

The plaintiff, a trustee appointed to wind down the Waterford Debtors' estates, argued that a deviation from the parties' pre-preference payment history precluded UPS from asserting the objective OCB defense. The plaintiff identified three distinct periods, beginning six months before the Waterford Debtors' bankruptcy filings, and observed that the average days-to-pay in the second period (72 days) was significantly higher than the average days-to-pay in the first and third periods (49 and 44 days, respectively). The plaintiff then argued that this discrepancy between the periods is evidence that the Waterford Debtors had accelerated payments to UPS and, therefore, the payments could not be shielded by the objective prong of the OCB defense.

The court rejected the plaintiff's argument that the deviation from the parties' past practices precluded UPS from asserting an objective OCB defense because the plaintiff was conflating the objective and subjective elements. The *Waterford Wedgwood*, court relying on an earlier Second Circuit decision, *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, concluded that the historical experience between the Debtor and UPS is irrelevant to the applicability of the objective element of the OCB defense because its focus should be on the practices in the relevant industry.

On the other hand, the *National Gas* court took a more fact-specific approach to the ordinary business terms defense in holding that the objective OCB defense did not protect the alleged preference payments. The court noted that the objective part of the OCB defense requires an examination of more than just the standards of the creditor's industry. The court considered the industry standards of both the creditor and the debtor, as well as the general business standards that are common to all business transactions in all industries in determining whether a transfer satisfies the objective OCB defense. Although the defendant submitted an affidavit stating that the transfers at issue were made in a manner typical of the banking industry, the court concluded that the transfers were non-ordinary because the debtor's conduct did not conform to the standards of the debtor's industry or with general sound business practices. Despite the lack of unusual collection activities by the defendant, the court determined that the debtor was in financial distress when the debtor made the alleged preference payments to the defendant and was trying to pay off those debts for which the debtor's owners had personal liability.

How do Courts Analyze Whether a Transfer is Made Pursuant to "Ordinary Business Terms"?

In *Waterford Wedgwood*, the court applied the trustee's proposed objective OCB industry range of one standard deviation off of the shipping industry mean of 42 days and held that payments made 30 to 54 days (+/- 12 days from the mean) after invoice date were made within ordinary industry terms. The court rejected as too broad UPS' objective ordinary course analysis that had relied on CRM DSO data in the shipping industry from 2008 and 2009, and then eliminated the top 5% and bottom 5% of the DSO for both years. This resulted in industry OCB ranges of 14 to 70 days-to-pay in 2008 and 16 to 72 days-to-pay in 2009.

While the *Waterford Wedgewood* court determined that an objective OCB range covering 90% of the reporting companies' DSO was too broad, the United States Bankruptcy Court for the District of Delaware, in *HLI Creditor Trust v. Metal Technologies Woodstock Corporation f/k/a Metal Technologies Woodstock, Ltd. (In re Hayes Lemmerz International, Inc.)*, held that relying on an objective OCB range covering only 50% of the surveyed companies' receivables collection information was too narrow. In *Hayes Lemmerz*, the defendant, Metal Technologies, relied on expert testimony concerning the timing of the collection of receivables. Metal Technologies' expert relied on industry data from D&B (Standard Industrial Classification Code 3321, the gray and ductile iron foundry category) ("SIC 3321"). The expert also relied on industry data from two reports compiled by Capital IQ. One report covered 203 automotive component companies and the other report covered 66 companies that produced a variety of different automotive parts. With respect to the report covering 203 companies, Metal Technologies' expert divided the payment data from the 52.4 day median days-to-pay into upper and lower quartiles, such that the OCB range of the middle 50% was 41.1 to 64.6 days-to-pay. The expert also reviewed different sub-groupings of the data, which produced the middle 60% ranging from 39 to 67.6 days and the middle 75% from 30.4 to 79 days-to-pay. With respect to companies in the report covering 66 companies, the middle 50%, 60% and 75% ranged between 45.4 to 67.6 days-to-pay, 42.8 to

69.7 days and 40.6 to 84.5 days-to-pay, respectively. This compared to payments by the debtors to Metal Technologies averaging 63.8 days during the preference period. The expert also testified that Metal Technologies was a tier 2 supplier while the debtors were tier 1 suppliers, and that the appropriate industry was the broad automotive supply industry. The expert also testified that the payment terms utilized by the Metal Technologies, "net 60, prox. weekly", were consistent with industry practices and the alleged preference payments were ordinary in the industry.

To the contrary, plaintiff's expert only relied on the SIC 3321 D&B data and apparently disregarded the Capital IQ data. This data reflected collection periods ranging between 40 and 55 days with a 48 day mean. The expert also testified that transfers paying invoices more than 65 days after invoice date were not paid according to "ordinary industry terms." By only relying on data from SIC 3321, the plaintiff's expert tried to pigeonhole Metal Technologies into a "very narrow industry". In support of the narrow industry, the expert also testified that the SIC 3321 data was more representative of Metal Technologies' industry than the Capital IQ data provided by Metal Technologies. The Capital IQ data included both tier 1 and tier 2 companies, many of which, unlike Metal Technologies, were large and publically held.

The court held in favor of Metal Technologies and determined that all of the alleged preference payments were shielded from preference risk by the objective OCB defense. The court relied on the fact that payments of invoices from 50 to 75 days after invoice date fell within the range of payments in the debtor's industry and rejected the data relied upon by plaintiff's expert as too narrow and strict under the *Molded Acoustical* and *Tolona Pizza* tests. The approach permitted virtually no deviation from the collection results of the middle 50% of SIC 3321 surveyed companies. In addition, the court determined that plaintiff's expert did not provide any evidence as to whether the middle 50% of the SIC 3321 companies were actually comparable to Metal Technologies.

The *AFA Investment* court also recently addressed conflicting arguments over the appropriate use of industry data when applying the objective prong of the OCB defense. AFA Investment Inc. and certain affiliates (collectively, the "AFA Debtors") had a relationship with the defendant, Smith & Sons Meat Packing Company ("Smith") that started several years prior to the preference period. In 2012, during the preference period, Smith had received payments totaling $2,273,500.00 from the AFA Debtors. Smith's preference exposure was reduced to $215,664.61 (the "Remaining Preference Claim") after the application of the new value defense. Smith invoked the subjective (discussed earlier) and objective parts of the OCB defense as a full defense to the Remaining Preference Claim.

Smith's expert concluded that the invoices paid related to the Remaining Preference Claim, which payments ranged from 27 to 59 days after invoice date, satisfied the objective part of the OCB defense. The expert relied on two categories of data from BizMiner, a service which provides information for various industries. The first did not distinguish between the actual annual sales of the companies that were surveyed, while the second only included companies with comparable annual sales to Smith.

The BizMiner data showed that the average DSO in Smith's industry (notwithstanding annual sales amount) was 51.18 days in 2010, 46.25 days in 2011 and 22.25 days in 2012. Smith's expert also relied upon BizMiner data that only included companies with comparable annual sales to Smith 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 improvement in the timing of collections in Smith's industry. The expert also reviewed data from RMA. The RMA data was comprised of 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 AFA Debtors' expert, relying on the same sources of data as Smith's expert, concluded that the objective OCB defense did not apply to shield Smith from preference liability. The AFA Debtors' expert rejected Smith's expert's reliance on industry data from 2010 and 2011 because the preference payments were all made in 2012 when payments in Smith's industry were considerably faster.

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

Similarly, the court did not understand why Smith's expert relied on the RMA report, which covered only April 1, 2010 through March 30, 2011, and not 2012. Significantly, there was an available RMA report (not relied upon by Smith's expert) that covered the preference period and included an average DSO of 20 days, which supported the AFA Debtors' position that the objective OCB defense did not apply.

II. <u>THE NEW VALUE DEFENSE</u>

The new value defense, contained in section 547(c)(4) of the Bankruptcy Code, states as follows:

> The trustee [or debtor-in-possession] may not avoid under [section 547(b)] a transfer [as a preference] –
>
> > . . . to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor –
> >
> > > (A) not secured by an otherwise unavoidable security interest; and
> > >
> > > (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

A creditor satisfies the new value defense to reduce its preference liability by proving that the creditor had sold goods or provided services to the debtor on credit terms after an alleged preference. Bottom line: after applying this defense, the debtor's unsecured creditors should be no worse off by the alleged preference payment to the extent of the new value the creditor subsequently provided to the debtor. This defense, like other preference defenses, encourages creditors to continue selling and extending credit to troubled companies.

Must New Value Remain Unpaid?

New value that remains unpaid on the bankruptcy filing date always reduces preference liability. However, courts have reached conflicting holdings on whether new value that was ultimately paid during the preference period should reduce preference liability.

Those courts that have allowed paid new value to reduce preference liability have relied on the language of section 547(a)(4)—a transfer may not be avoided as a preference to the extent that after such transfer, such creditor gave new value to the debtor "on account of which new value the debtor did not make an otherwise unavoidable transfer to…such creditor." Section 547(c)(4) clearly states that paid new value must be allowed where the payment for the new value is avoidable as a preference. If, on the other hand, the payment for the new value is protected by another preference defense (such as the OCB or other defenses), the paid invoices cannot be counted as part of the creditor's new value defense. These courts have also noted that the potential preference recovery on account of the paid new value replenishes the bankruptcy estate.

Those courts that have not allowed paid new value as part of a creditor's new value defense have reasoned that there is no benefit to the estate where the new value was paid. Creditors asserting paid new value as part of their new value defense would receive a double benefit because they received payment for the new value and then were also able to use the new value to reduce their preference liability.

In *Miller v. JNJ Logistics LLC (In re Proliance Int'l, Inc.)*, the United States Bankruptcy Court for the District of Delaware affirmed the applicability of the paid new value defense. This was the third decision in a row by a bankruptcy judge in the Third Circuit, which includes the Delaware Bankruptcy Court, that has allowed paid new value. In *Proliance* the trustee sued the defendant, JNJ Logistics LLC ("JNJ") for recovery of a preference claim that included 12 payments totaling $548,035.66. JNJ had an undisputed unpaid new value defense of approximately $49,368.28 based on unpaid invoices owing on the filing date. JNJ also asserted a paid new value defense in the amount of $222,045.11 based on invoices that were paid during the preference period, which the trustee contested.

The *Proliance* court held that JNJ could assert both paid and unpaid new value as part of its new value defense, reducing JNJ's preference exposure by $271,411.38. Of note, while the court allowed the paid new value because the transfers that paid the new value were "otherwise avoidable" as preferential transfers, the court did not condition its holding on the trustee's recovery of the payments for the new value. This suggests a potential expansion of the paid new value defense to allow new value that was paid by a transfer protected by another preference defense.

New Value that is Paid or Returned, Post-Petition Pursuant to Court Order

The paid new value defense has been further complicated where the new value was paid for or the creditor otherwise recovered the new value after the bankruptcy filing. This occurs where (1) a creditor received payment of the new value post-petition pursuant to court order, such as a critical vendor order, or (2) the creditor reclaimed the goods that were part of its new value defense, or (3) the debtor returned the new value to the creditor. The few courts that have addressed this issue have reached conflicting holdings over whether a creditor's new value defense would be reduced by the debtor's post-petition repayment or return of new value pursuant to a court order.

When making this determination, the courts have had to consider the relevant point in time for determining whether new value is paid or remains unpaid. Some courts have made this determination as of the bankruptcy filing date, meaning that new value will be treated as unpaid if the goods or services were not paid for or returned by the bankruptcy filing date (regardless of what happened after the filing). Other courts have held that new value ultimately paid or returned after the bankruptcy filing did not qualify as a preference defense because it would amount to a double-dip. Put another way, where the payment of the new value is itself not avoidable as a preference, the new value that it paid cannot then be counted.

Two more recent cases have addressed this issue. The Bankruptcy Court for the District of New Mexico, in *Gonzales v. Food Marketing Group (In re Furr's Supermarkets, Inc.)*, held that new value could not be used to offset preference liability where the new value was paid pursuant to a court order after the bankruptcy filing. The Third Circuit, in *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's Inc)*, reached the opposite conclusion, ruling that a creditor could assert new value paid after the bankruptcy filing pursuant to a court order to reduce preference liability.

In *In re Furr's Supermarkets, Inc.*, the New Mexico Bankruptcy Court held that new value paid after the bankruptcy filing could not be invoked as part of the creditor's new value defense because the bankruptcy filing date is not relevant for computing the new value defense. *Furr's* involved the debtors' payment of $180,000 of employees' insurance premiums to Sun Life Insurance during the preference period. As of the bankruptcy filing date, Sun was owed $125,000 on account of insurance that was provided after Sun had received the $180,000 in alleged preferences. After the bankruptcy filing, the debtor paid Sun $60,000 of the unpaid premiums pursuant to bankruptcy court orders. Furr's Chapter 7 trustee sued Sun for the return of the $180,000 Sun had received during the 90-day preference period. Sun claimed that it was entitled to a new value offset for the entire $125,000, reducing its preference liability to $55,000. The trustee countered that the $125,000 of new value that Sun had provided must be reduced by the $60,000 Sun had received after the bankruptcy filing pursuant to the court orders approving the debtor's post-petition payment of pre-petition employee benefits, allowing Sun to claim only $65,000 of new value, and only reducing its preference exposure to $115,000.

The bankruptcy court sided with the trustee and ruled that the court must determine whether the new value had ultimately been paid, regardless of whether it was paid before or after the bankruptcy filing. The debtor's payment of the new value, whether before or after the filing, depleted the estate and diminished the return to creditors. It made no economic sense to count such new value just because it was paid after the bankruptcy filing.

By contrast, in *In re Friedman's Inc.*, the United States Court of Appeals for the Third Circuit, held that new value paid after the bankruptcy filing did not negate the applicability of the new value defense. In *Friedman's*, the debtor had made payments totaling $82,000 to Roth Staffing for personnel. Following these preferential payments, but before the bankruptcy was filed, Roth Staffing had provided additional services valued at $100,000 to the debtor. These services remained unpaid as of the bankruptcy filing date. After filing bankruptcy, the debtor moved in the bankruptcy court for authority to pay its employees' and independent contractors' pre-petition wages, compensation, and related benefits in order to avoid an employee exodus. The bankruptcy court granted the debtor's motion by entry of a "wage order," akin to a critical vendor order. Pursuant to the wage order, after the bankruptcy filing, the debtor paid $72,000 to Roth Staffing on account of pre-petition staffing services. Thereafter, the liquidating trustee, who at the time of the lawsuit had stepped into the debtor's shoes, sued Roth Staffing to avoid and recover the pre-petition payments as preferences. The amount of Roth Staffing's preference exposure depended on whether the new value it had provided should have been reduced by the $72,000 of payments Roth Staffing had received pursuant to the wage order after the bankruptcy filing. If the new value was not reduced, Roth Staffing would have no preference liability because the preference payment of $82,000 was less than the $100,000 in services Roth Staffing had provided after receiving the preference payment. Roth Staffing's preference liability would have been $54,000 if the new value was reduced by the $72,000 of payments Roth Staffing had received after the bankruptcy filing because the $100,000 of services Roth had provided would have been reduced to $28,000.

The Third Circuit court held, contrary to the ruling of New Mexico Bankruptcy Court in *Furr's*, that preference exposure and the computation of new value should be determined on the bankruptcy filing date, regardless of whether that new value was paid by the wage order. The *Friedman's* court disagreed with the holding of the *Furr's* court that the debtor had depleted the estate and diminished the return to creditors by paying for the new value post-petition (and, therefore, the defendant should not be entitled to then count the new value). The *Friedman's* court noted that *Furr's* and the other courts that had focused on "replenishment" and "equality" had lost sight of the real bankruptcy policy objectives, which is for creditors to continue to provide goods and services to a debtor during the debtor's decline and to deter a race to the courthouse.

Post-Petition New Value and Set-Off

The courts have also grappled with whether a creditor can include unpaid post-petition shipments or services as part of its new value defense. A majority of the courts do not allow post-petition new value. Both the Delaware bankruptcy and district courts in *Burtch v. Prudential Real Estate and Relocation Services, Inc., et al. (In re AE Liquidation, Inc.)*, recently held that only new value extended prior to a bankruptcy filing should reduce preference liability. The district court relied on the Third Circuit's holding in *Friedman's* (discussed above) that the bankruptcy filing date is the cutoff date for determining new value.

The United States Bankruptcy Court in Delaware, *In re Quantum Foods, LLC*, recently allowed a preference defendant to assert its setoff rights with respect to its allowed unpaid post-petition administrative priority claim as a counterclaim to reduce the defendant's preference liability. The court noted that it was not relying on a post-petition new value defense, accepting the generally accepted rule that new value must be provided prior to the bankruptcy filing. The court also found that the defendant had satisfied the mutuality requirement for setoff where both the preference claim (which could only have been brought after the bankruptcy filing) and the creditor's administrative claim were post-petition claims.

Conclusion

While a vigilant debtor or trustee will seek to invalidate a creditor's OCB or new value defenses, a creditor should arm itself to support these defenses. That is the key to providing a creditor with increased leverage to resolve its preference exposure on the most favorable terms.

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