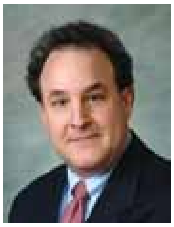
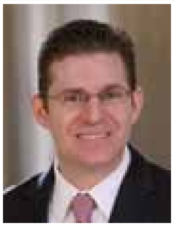

BRUCE NATHAN, ESQ. AND DAVID BANKER, ESQ

Delaware Bankruptcy Court Grants Summary Judgment Dismissing Preference Complaint Based on Ordinary Course of Business Defense Without a Trial!

While trade creditors have become increasingly savvy about asserting the ordinary course of business preference defense, they are often humbled by the reality that an aggressive and unreasonable plaintiff may threaten to go “all the way” to trial. In fact, a trial is often the first time a defendant will obtain a definitive ruling on the applicability of the ordinary course of business defense because the courts usually conclude the defense is too “fact sensitive” and, therefore, is not ripe for summary judgment dismissing the complaint. Unfortunately for creditors, the threat to go “all the way” to trial is quite real. Continuing the litigation, dealing with discovery and going to trial can become time-consuming and expensive.

However, the United States Bankruptcy Court for the District of Delaware, in the *Conex Holdings, LLC* bankruptcy case, recently granted summary judgment dismissing a preference complaint based on the ordinary course of business defense. The creditor thereby avoided substantial legal fees and other expenses that would have otherwise been incurred in the event of a long, drawn-out litigation, including a trial.

> A creditor that cannot satisfy the subjective requirement of the ordinary course of business defense can still escape preference liability by proving that the alleged preference was paid according to ordinary business terms.

The *Conex* court (the “court”) found incontrovertible proof that the alleged preference payments were consistent with the parties’ course of dealing and payment history, and, therefore, satisfied the subjective part of the ordinary course of business defense. The court first held that the parties’ approximately 16-month relationship prior to the 90-day preference period, involving 20 payments, was sufficient to determine an ordinary course of dealing between the parties. The court then found that the timing of the alleged preference payments was consistent with the timing of the payments

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prior to the preference period and disregarded small differences in timing. When comparing the average number of days for the debtor to pay the creditor’s invoices prior to and during the preference period, the court did not consider a difference of seven days (when including outlier payments prior to the preference period) and two days (excluding such outliers) to be sufficient to justify the loss of the subjective ordinary course of business defense. The court also concurred with the defendant’s payment history analysis that included several payments where the check was made payable to another entity. The court found that the defendant had submitted undisputed proof that both the defendant and the other entity were the same. Finally, the court took into account the consistency in the amount of the payments and the manner in which they were tendered prior to and during the preference period and the absence of any unusual collection or other action by the creditor to gain an unfair advantage as a result of the debtor’s deteriorated financial condition.

The Ordinary Course of Business Defense to Preference Claims

Bankruptcy Code Section 547(b) sets forth the requirements for proving a preference claim. After a debtor or trustee satisfies all of Section 547’s requirements, the defending creditor can seek to reduce or eliminate preference exposure by satisfying one or more of the preference defenses contained in Bankruptcy Code Section 547(c). These defenses are supposed to encourage creditors to continue doing business with, and extending credit to, financially distressed customers.

The ordinary course of business defense, set forth in Section 547(c)(2), is one such preference defense. The 2005 amendments to Section 547(c)(2) made it easier to prove the ordinary course of business defense. Section 547(c)(2) requires a creditor to prove that the alleged preference paid indebtedness incurred in the ordinary course of business or financial affairs of the debtor and the creditor; and *either* the payment (A) was made in the ordinary course of business or financial affairs of the debtor and the creditor; *or* (B) was made according to ordinary business terms. The first requirement of the ordinary course of business defense, that the debt was incurred in the ordinary course of business of the debtor and creditor, is rather straightforward and can be proved by the creditor's extension of trade credit to the debtor. The second requirement, that the payment was made in the ordinary course of business of the debtor and creditor, is subjective in nature. It requires the creditor to show some consistency between the alleged preference payment and the debtor's and creditor's payment history and other aspects of their relationship.

A creditor that cannot satisfy the subjective requirement of the ordinary course of business defense can still escape preference liability by proving that the alleged preference was paid according to ordinary business terms. This part of the ordinary course of business defense is objective in nature. It requires proof that the alleged preference payment was consistent with the payment practices and range of terms in the creditor's industry, the debtor's industry, or some subset of either or both.

The ordinary course of business defense is usually so fact intensive as to preclude a creditor from obtaining summary judgment dismissing a preference complaint. Luckily for the creditor in the *Conex* case, the court granted summary judgment dismissing the preference complaint based on an absence of disputed facts in connection with the creditor's proof of the subjective part of the ordinary course defense.

The Facts of the Conex Case

Conex was a general mechanical contracting and industrial services firm. The defendant, Industrial Specialists (formerly Brand Industrial Solutions, LLC), was a subcontractor to Conex on construction projects for oil refineries located in Texas. Conex contracted with various owners of real property located in Texas to perform certain labor and furnish certain materials in connection with the construction and completion of oil refineries. In turn, Conex subcontracted with the defendant to furnish certain labor and/or material in connection with these projects, which included the defendant receiving 20 payments from Conex over a period of 23 months prior to Conex's bankruptcy filing.

On Feb. 21, 2011, involuntary petitions for relief under Chapter 11 of the Bankruptcy Code were filed against Conex and certain of its subsidiaries (collectively, the "debtors") in the U.S. Bankruptcy Court for the District of Delaware. On Feb. 24, 2011, the debtors' involuntary Chapter 11 cases were consensually converted to voluntary liquidation cases under Chapter 7 of the Bankruptcy Code, and the Office of the United States Trustee appointed Charles A. Stanziale, Jr. as trustee for the debtors' estates (the "trustee").

In December 2012, the trustee commenced an adversary proceeding against the defendant, Industrial Specialists, seeking to avoid and recover $1,181,583.84 in alleged preferential transfers. The transfers consisted of seven payments the debtors had made to the defendant during the 90 days preceding the filing of the debtors' bankruptcy cases.

> The defendant contended there was no issue of fact as to the applicability of the subjective ordinary course of business defense, warranting summary judgment dismissing the preference complaint.

The defendant subsequently filed an answer and asserted the subjective ordinary course of business defense. Thereafter, the defendant filed a motion for summary judgment, seeking dismissal of the preference complaint. The defendant argued, in part, that the alleged preferences were made in the ordinary course of business of the debtors and the defendant, and had, therefore, satisfied the requirements of the subjective part of the ordinary course of business defense. The defendant asserted that no dispute existed concerning the consistency of the alleged preference payments with the debtors' prior payments to the defendant as to timing, amount and manner of delivery of the payments, and the circumstances surrounding the payments. The trustee opposed the defendant's summary judgment motion, asserting the existence of issues of material fact that warranted his continued prosecution, including a trial, of the preference action.

The Parties' Arguments

The trustee and the defendant disagreed over whether the alleged preference payments were paid in the ordinary course of their business relationship. That required the court to compare the timing, amount and circumstances of the alleged preference payments with the debtors' payments to the defendant over a sufficient period of time prior to the preference period, and to nail down the methodology for making this comparison.

In support of the subjective ordinary course of business defense, the defendant asserted that prior to the preference period, the defendant had usually received the debtors' payments between 41 and 70 days after invoice date, except for a few outlier payments made 95, 81, 78, and 77 days after the invoice date. During the preference period, the defendant received all payments between 41 and 68 days after invoice date, nearly identical to the debtors' timing of payment prior to the preference period if the outlier payments are excluded. Moreover, if the outliers are excluded from the history, the debtors' average days to pay was 54 days from invoice date during the preference period compared to 56 days from invoice date prior to the preference period; once again, nearly identical.

The following chart included in the *Conex* decision demonstrates the nearly identical timing of Conex's seven alleged preference payments made to the defendant during the preference period when compared to the 20 payments made prior to the preference period:

	Average Days to Pay	Average Range of Days to Pay	Median
Historical Period (actual)	61	41–95	62
Historical Period (excluding four outliers)	56	41–70	55
Preference Period	54	41–68	55

In addition, the defendant argued that there was no difference in the manner, method and circumstances of the debtors' payments of the alleged preferences compared to the payments made prior to the preference period. The defendant claimed that each payment during the preference period was received squarely within the historical range of days to pay after invoice date and was consistent with the parties' prior course of dealings. As a result, the defendant contended there was no issue of fact as to the applicability of the subjective ordinary course of business defense, warranting summary judgment dismissing the preference complaint.

In contrast, the trustee disputed the historical days-to-pay range provided by the defendant because of its omission of the outlier payments made prior to the preference period. The trustee argued that the outlier payments must be included in the defendant's payment history, resulting in an average days to payment from invoice date of 61 days prior to the preference period, a seven-day difference when compared to the average days to payment from invoice date of 54 days during the preference period. The trustee claimed this seven-day deviation in days to payment was sufficient to prove that the alleged preferences were paid differently compared to the payments prior to the preference period, and, therefore, were not protected by the subjective ordinary course of business defense.

The trustee also argued that the data presented by the defendant was skewed and that a "dollar-weighted days sale outstanding (DSO)" analysis was more appropriate. This analysis takes into account both the timing of the payment, as well as the amount of the invoice paid, and gives more weight to larger invoices. In fact, as reflected in the following chart, the dollar-weighted DSO for the alleged preference payments was 60.6 days, compared to 79 days prior to the preference period.

	Dollar-Weighted Days Sales Outstanding ("DSO") Analysis	Percentage of Invoices Paid Within 70 days of the Invoice Date
Historical Period (actual)	79.0	38.09%
Preference Period	60.6	100%

The trustee also argued that most invoices were paid faster during the preference period than prior to the preference period. By way of example, 12 out of 14 invoices (86%) paid during the preference period were paid within 55 days of invoice date, and 100% of the invoices paid during the preference period were paid within 70 days of invoice date. In contrast, only eight out of 20 invoices (40%) paid prior to the preference period were paid within 55 days of invoice date, and only 38% of invoices paid prior to the preference period were paid within 70 days of invoice date. This drastic change (e.g. the percentage of invoices paid within 55 days of invoice date more than doubled), clearly demonstrated an acceleration in the timing of the debtors' payments of invoices during the preference period.

Finally, the trustee noted that while in some instances during the pre-preference period, the payee was Brand Industrial, rather than the defendant, Industrial Specialists, had received all of the alleged preferences. The trustee sought to exclude the debtors' payments to Brand Industrial as part of the historical analysis of the parties' course of dealing prior to the preference period, arguing the defendant had failed to prove that Brand Industrial and the defendant were the same entity.

As a result, the trustee asserted the defendant was not entitled to summary judgment dismissing the complaint because there were facts in dispute concerning the consistency of the alleged preference payments compared to the payments made prior to the preference period. This precluded the court from granting relief because the defendant could not satisfy its burden of proving the subjective ordinary course of business defense.

The Court's Ruling Granting Summary Judgment Dismissing the Preference Complaint

The court granted the defendant's motion for summary judgment and dismissed the preference complaint. The court found no material issues of fact and concluded that the defendant had satisfied all the requirements of the subjective component of the ordinary course of business defense.

Neither the trustee nor the defendant disputed that the debtors had incurred the indebtedness paid by the alleged preference payments in the ordinary course of business of the debtors and the defendant. The debtors had operated as a general industrial contractor, and the defendant was a subcontractor employed to assist on a construction project. The debts related to the alleged preferences arose out of the defendant's work on the construction project.

The *Conex* court then relied on the following factors in determining whether a payment was ordinary between the parties: (1) the length of time the parties engaged in the type of dealing at issue; (2) whether the subject transfers were in an amount more than usually paid; (3) whether the payments at issue were tendered in a different manner from previous payments (e.g. check versus wire); (4) whether the debtors or creditor engaged in any unusual action to collect or pay the debt (e.g. undue payment pressure); and (5) whether the creditor did anything to gain an advantage (such as obtaining additional security) in light of the debtors' deteriorating financial condition.

Considering the first factor (the length of time the parties engaged in their course of dealings), the court found that a 16-month payment history prior to the preference period was "of sufficient duration" to determine the ordinary course of dealings between the parties. Next, the court utilized a days-to-pay analysis to evaluate whether the alleged preference payments were paid consistently with the debtors' payments to the defendant prior to the preference period. The court did not find either the two-day difference in average days to pay (when excluding outlier payments prior to the preference period) or the seven-day difference in average days to pay (when including outlier payments prior to the preference period) to be sufficiently problematic as to take the alleged preferential transfers outside of the debtors' and the defendant's normal course of dealings. The court declared that small deviations in timing of payment do not preclude the applicability of the subjective ordinary course of business defense. The court also rejected the trustee's "dollar-weighted DSO" based on the lack of any legal authority supporting this analysis.

The court also opted to include the debtors' payments to Brand Industrial prior to the preference period as part of the parties' payment history, which further supported the consistency of the alleged preference payments with the parties' prior course of dealing. The defendant had submitted sufficient proof that the defendant, Industrial Specialists, and Brand Industrial, were the same entity.

The court also recognized that there were no differences in the manner, method and circumstances in the payment of the alleged preferences compared to the payments made prior to the preference period. There was no evidence that the alleged preference payments were either larger than, or tendered in a different manner than, prior payments. In addition, the defendant did not take any unusual action to either obtain payment or gain an advantage (by obtaining collateral to secure its claim) as a result of the debtors' deteriorating financial condition.

As a result, the court found no factual dispute over the consistency of the alleged preference payments compared to prior payments. This warranted summary judgment dismissing the preference complaint based on the subjective ordinary course of business defense.

Conclusion

The *Conex* ruling, granting summary judgment dismissing a pending preference action, based on the subjective prong of the ordinary course of business defense, provides a roadmap for creditors seeking to avoid the great expense of defending a preference litigation, including discovery and a trial. Unfortunately, the subjective portion of the ordinary course of business defense is just so darn unpredictable. The same facts the *Conex* court had relied upon in concluding that a preference defendant had acted no differently prior to and during the preference period may raise questions of fact that could prompt another court to deny summary judgment and force the defendant to continue the litigation through trial.

> As a result, the court found no factual dispute over the consistency of the alleged preference payments compared to prior payments. This warranted summary judgment dismissing the preference complaint based on the subjective ordinary course of business defense.

Bruce S. Nathan, Esq. is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group 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 and is a former member of the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

David M. Banker, Esq. is a partner in the law firm of Lowenstein Sandler LLP. He practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and focuses his practice on trade creditors' rights. David can be reached at dbanker@lowenstein.com.