



Rolling the Dice: Proving the Subjective Ordinary Course of Business Defense at Trial

Most preference claims never make it to trial because the process is expensive and unpredictable. One of the most unpredictable aspects of preference litigation is how courts in different jurisdictions (and sometimes within the same jurisdiction) rule on the applicability of the ordinary course of business (“OCB”) defense to a preference claim. The Bankruptcy Court for the District of Delaware, in *Burtch v. Revchem Composites, Inc. f/n/a Revchem Plastics (“Revchem”)*, recently dismissed a preference complaint, after trial, where the creditor had satisfied the subjective component of the OCB defense.

The court’s decision in *Revchem* was notable because the court applied the subjective prong of the OCB defense even though the alleged preference payments were made much faster than prior payments. The court went beyond a simple average days-to-pay comparison of payments prior to and during the preference period and focused on the reasons for the faster payments. The court ultimately held that faster payments could still be subjectively ordinary where they enabled the debtors to remain within or close to an agreed credit limit and neither the debtors nor the creditor had engaged in any unusual behavior in collecting or tendering payment.

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The *Revchem* decision also provides valuable guidance to trade creditors seeking to satisfy the objective prong of the OCB defense. The court held that a creditor did not satisfy the objective OCB defense by just relying on its experienced employee’s general opinion testimony. The creditor also had to submit objective evidence (e.g., statistical analysis) to prove what is ordinary in the industry.



The OCB Defense

After a trustee satisfies all of the elements of a preference claim contained in Section 547(b) of the Bankruptcy Code, a creditor seeking to avoid preference liability has the burden of proving one or more of the preference defenses contained in Section 547(c) of the Bankruptcy Code. The OCB defense, contained in Section 547(c)(2) of the Bankruptcy Code, is one of the most frequently relied upon preference defenses. The intent of the defense is to encourage creditors to continue doing business with their financially distressed customers.

A creditor must first prove that an alleged preference paid indebtedness incurred in the ordinary course of the debtor’s and creditor’s business or financial affairs. This requirement is easy to prove based on the creditor’s extension of trade credit to the debtor. The creditor must then prove that the payment was either (1) made in the ordinary course of the debtor’s and creditor’s business or financial affairs, or (2) made according to ordinary business terms.

The debtor’s payment in the ordinary course of the debtor’s and creditor’s businesses is referred to as the subjective component of the OCB defense. A creditor must prove some consistency between the alleged preference payments and the debtor’s and creditor’s payment history and other aspects of their relationship. When analyzing the subjective part of the OCB defense, the courts, including the *Revchem* court, have considered numerous factors, including: (i) the length of the

parties' business relationship; (ii) the amount and timing of the debtor's payments both during and before the preference period; (iii) the manner (e.g., check, wire transfer, etc.) in which the debtor made the payments both before and during the preference period; (iv) any unusual action by either the debtor or creditor concerning payment or collection of the creditor's claim; and (v) whether the creditor did anything to obtain an advantage in light of the debtor's deteriorating financial condition.

A creditor can also prove the OCB defense by satisfying the "ordinary business terms" or objective component of the defense. The alleged preference payment must have been consistent with the payment practices and range of terms in the creditor's industry, the debtor's industry, or some set of either or both to satisfy this prong.

Facts

Revchem was in the business of distributing reinforced plastic composites. Revchem's and the Debtors' business relationship began in February of 2004. From the outset of the parties' relationship, the Debtors' payment terms and credit limit were governed by an oral agreement. From February of 2004 through April of 2007, Revchem provided the Debtors with net 30 day payment terms. From late April 2007 through the Debtors' bankruptcy filings, Revchem extended the Debtors'

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payment terms to net 60 days. Revchem also provided the Debtors with a \$150,000 credit limit from May 2007 through August 2008.¹ Throughout the parties' relationship, whenever the Debtors exceeded the credit limit, Revchem worked informally with the Debtors to reduce their outstanding balance to within the credit limit.

The Debtors usually paid invoices by check, but on occasion paid with a credit card or wire transfer. Prior to the 90-day preference period, from February 2004 through April 2008, the Debtors placed 477 orders with, and made 190 separate payments to, Revchem. The size of the Debtors' payments to Revchem ranged from \$5 to \$27,000, the days-to-pay from invoice date to the date of payment was from 0 to 116 days, and the average days-to-pay was 55.22 days. The Debtors were also making payments under both net 30 day payment terms through April 2007 and net 60 day payment terms from late April 2007 through the bankruptcy filing.

During the preference period, between May and August of 2008, the Debtors placed 133 orders with, and made 28 payments to, Revchem. The size of the payments ranged from \$33 to \$50,000; the days-to-pay was from 13 to 61 days; and the average days-to-pay was 27.3 days.

Throughout the parties' relationship, the Debtors attempted to stay within their credit limit by tying specific invoices or portions of invoices to each payment. If the Debtors' payments did not refer to specific invoices to be paid, Revchem applied the payments to pay the Debtors' oldest outstanding invoices.

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During the preference period, on several occasions, the Debtors were at or near their credit limit with Revchem. Revchem then required the Debtors to pay previously issued invoices as a condition to Revchem delivering new product in order to reduce the Debtors' indebtedness to Revchem below the credit limit. At no time did Revchem engage in any aggressive collection activity in an effort to reduce the Debtors' outstanding balance.

During the 18 months prior to the petition date, the Debtors worked on a construction project. During the preference period, the Debtors ordered product from, and paid invoices to, Revchem faster than in the past in response to the project's upcoming completion deadline. The Debtors also accelerated payment of Revchem's invoices to maintain the balance owing by the Debtors to Revchem at or near the credit limit.

The Preference Litigation

On Aug. 29, 2008 (the "Petition Date"), Trevi Architectural Inc. and its parent company Sierra Concrete Design, Inc. (collectively, the "Debtors") filed voluntary Chapter 7 petitions. A Chapter 7 trustee was then appointed.

On Aug. 19, 2010, the trustee commenced a lawsuit against Revchem. The trustee sought to avoid and recover 27 payments totaling \$612,879.94 the Debtors had made to Revchem during the preference period (the "Preference Payments"). Revchem answered the complaint.

Revchem then moved for summary judgment dismissing the preference complaint, based, in pertinent part, on the OCB and subsequent new value defenses. The court granted summary judgment dismissing the complaint for \$504,795.23 of the Preference Payments where Revchem had satisfied the new value defense. However, the court denied summary judgment on the OCB defense with regard to \$108,084.71 of the payments (the "OCB Payments") because Revchem had

failed to provide sufficient proof of the history of the parties' relationship. As a result, the court conducted a trial on the OCB defense.

At trial, Revchem presented the testimony of its owner and CEO and trial exhibits containing every invoice from February 2004 through the Petition Date to support the applicability of the subjective OCB defense. The exhibits included invoice dates, invoice amounts, payment receipt date, and the number of days between invoice date and payment date.

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The Court's Decision

The Subjective OCB Defense

The court ruled that Revchem had satisfied the subjective component of the OCB defense and, therefore, had no preference exposure. The court first determined that the parties' four-and-a-half-year relationship encompassing 610 transactions was a sufficient course of dealing to demonstrate an ordinary course of dealing between the parties.

The court then considered whether the OCB payments were sufficiently similar to the Debtors' payments to Revchem prior to the preference period in order to determine whether the OCB payments satisfied the subjective element of the OCB defense. The court noted that the following aspects of the parties' relationship were the same prior to and during the preference period: (a) the same credit arrangement was in effect, (b) most payments were made by check, (c) there was no unusual collection activity by Revchem or unusual action by the Debtors to pay outstanding invoices, and (d) Revchem did not take advantage of the Debtors' deteriorating financial condition.

The court then compared the timing of the OCB Payments and the payments made prior to the preference period. 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. However, the court rejected the trustee's argument that the Debtors' faster payments during the preference period alone precluded Revchem from satisfying the subjective OCB defense.

The court distinguished its prior decision in *In re Archway Cookies* ("Archway") where the court had simply compared the average days-to-pay of all the payments made prior to and during the preference period.² The Archway court held that a 4.9 day difference in the average days-to-pay was not material

enough to disqualify Revchem from satisfying the subjective OCB defense. However, in Archway, unlike Revchem, the parties had always operated under net 20 day payment terms. As a result, the Revchem court found the Archway decision not applicable because prior to the preference period, Revchem had changed payment terms from net 30 days to net 60 days. The Revchem court also noted that unlike in Archway (i) the relationship between the Debtors and Revchem was always governed by a credit limit, and (ii) the Debtors were involved in a construction project that required Revchem's delivery of more goods than usual during the preference period as a result of an upcoming completion deadline, which, combined with the credit limit, resulted in the Debtors' faster payment of invoices.

The court rejected the trustee's argument that the Debtors' faster payments to Revchem during the preference period amounted to a material change in practice that precluded Revchem from satisfying the subjective OCB defense. Revchem had not placed any credit holds with respect to shipments to the Debtors either prior to or during the preference period. In addition, Revchem did not pressure the Debtors to pay outstanding invoices faster than usual during the preference period. Revchem merely notified the Debtors that they were near their credit limit, but did not take "an excessively hard line" in enforcing invoice terms or the credit limit. This was consistent with the Debtors' history of either paying invoices late or exceeding the credit limit and then paying invoices to Revchem to reduce the outstanding balance to comply with the credit limit. The court also relied on testimony that 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 payments prior to the preference period or that the Debtors were paying in a different manner.

At no time did Revchem engage in any aggressive collection activity in an effort to reduce the Debtors' outstanding balance.

Finally, the court relied on testimony that the credit limit was the only means available to Revchem to make sure that the Debtors were paying invoices in a timely manner and complying with the credit limit. The same credit limit was present in the year prior to the preference period and the parties had a history of working under a credit limit. 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 by the subjective OCB defense from preference liability.

Revchem's Failure to Satisfy the Objective Element of the OCB Defense

The court then considered whether Revchem could avoid preference liability by satisfying the objective prong of the

OCB defense. This required proof that the OCB payments were made according to ordinary business terms and were not “so idiosyncratic as to fall outside that broad range...” of practices that are followed in the creditor’s industry. Revchem relied on the testimony of its owner and CEO, who had 40 years of experience in the plastic composites industry (the creditor’s industry). He testified that it was ordinary in the industry for there to be credit limits, net 60-day payment terms, and oral contracts, without relying on any supporting data or reports. The trustee argued that the testimony was insufficient to prove the objective OCB defense because the witness did not review any industry documents or articles about the plastics composites industry, nor did he speak to any other CEOs or other individuals with expertise in the same industry. The court agreed with the trustee and held that

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Revchem did not satisfy its burden of proving what constitutes ordinary terms in the industry because the information Revchem relied upon was too general, lacking an objective basis and statistical analysis to support its witness’s testimony.

Conclusion

Application of the OCB defense—both the subjective and objective prongs—is extremely unpredictable and fact specific. All too often, identical sets of facts can result in conflicting holdings depending on the court in which a lawsuit is pending.

The *Revchem* court’s decision shows that bankruptcy courts may consider factors other than a comparison of days-to-pay historically and during the preference period in determining the applicability of the subjective prong of the OCB defense.³ The court ended up ruling that the Debtors’ faster payments during the preference period did not automatically prevent Revchem from satisfying the subjective OCB defense. The court relied on factors other than the faster payments during the preference period, such as the existence of a credit limit

throughout the parties’ payment history and the tight project deadline, to justify invoking the subjective OCB defense.

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The *Revchem* decision also points out the danger of a creditor relying on the general opinion testimony of an employee with many years of experience in the creditor’s industry to support the objective OCB defense. Such testimony alone, without any additional support, might not shield a creditor from preference liability based on the objective OCB defense. ▀

1. Revchem also maintained varying credit limits throughout the parties’ relationship.

2. Judge Christopher S. Sontchi rendered both the *Archway* and *Revchem* decisions.

3. This saga may not be over. On July 31, 2015, the trustee appealed the Revchem court’s ruling to the U.S. District Court for the District of Delaware. It is unclear when the District Court will hear the appeal.

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