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The Subjective Ordinary Course of Business Preference Defense: Tie Goes to the Plaintiff

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A trade creditor dealing with a financially distressed customer confronts an unfortunate Catch-22. The creditor will certainly want to take steps to protect itself from the risk of nonpayment, whether by tightening payment terms, reducing credit limits, threatening to withhold shipments, following up on payment of open invoices or engaging in other collection efforts.

However, as many trade creditors are aware, actions taken to reduce or prevent credit risk may cost the creditor its ordinary course of business defense if its customer files bankruptcy and a lawsuit is commenced to recover, as preferences, the payments made to the creditor in the 90 days leading up to the bankruptcy filing.

This harsh Catch-22 is highlighted in a January 2022 decision by the U.S. Bankruptcy Court for the Southern District of Indiana in the Chapter 11 cases of *hhgregg, Inc.* (*hhgregg*). In *hhgregg*, one of the debtor's key suppliers managed to eliminate its exposure before the bankruptcy filing by reducing its credit terms and credit limit, and undertaking additional collection efforts. These steps—which are largely consistent with best practices for reducing a financially distressed customer's credit exposure—resulted in a judgment against the supplier of over $3.5 million in a preference lawsuit because the supplier could not prove the ordinary course of business defense to the preference claim. Though the court acknowledged the decision was a "close call," it was the supplier's burden to "tip the scales in its favor." The *hhgregg* decision is a prime example of how a creditor's reasonable actions to collect its claim and reduce its exposure may ultimately cost the creditor the ordinary course of business defense and significantly increase the creditor's preference exposure.

Background on Preference Claims and Defenses

Pursuant to Section 547(b), a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving the following elements:

- The debtor transferred its property to or for the benefit of a creditor (the most frequent type of transfer is the debtor's payment from its bank account to a creditor) [Section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered [Section 547(b)(2)];
- The transfer was made when the debtor was insolvent, which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90 day preference period, which makes insolvency easier to prove [Section 547(b)(3)];
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [Section 547(b)(5)].

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

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

To satisfy the subjective component of the OCB defense (which was at issue in *hhgregg*), a creditor must prove some consistency between the alleged preference payments, and the payment history and relationship between the creditor and debtor. This defense usually requires a comparison of the timeliness and other characteristics of the payments made by the debtor to the creditor during the 90-day preference period with the payments made during some time period prior to the preference period. As illustrated by the *hhgregg* decision, the subjective OCB defense requires a fact intensive analysis that varies on a case-by-case basis.

The *hhgregg* decision is a prime example of how a creditor's reasonable actions to collect its claim and reduce its exposure may ultimately cost the creditor the ordinary course of business defense and significantly increase the creditor's preference exposure.

Facts and Background of the *hhgregg* Decision

On March 6, 2017 (Petition Date), hhgregg, Inc., Gregg Appliances, Inc., and HHG Distributing LLC (collectively, Debtors) filed Chapter 11 cases in the U.S. Bankruptcy Court for the Southern District of Indiana. The Debtors operated a multi-regional retail chain that sold appliances, consumer electronics, and other home products and services across 220 brick-and-mortar stores in 19 states and online. D&H Distributing Company (D&H), a technology distributor of consumer electronics and other goods, was one of the Debtors' key suppliers for almost a decade prior to the Petition Date.

The Debtors' financial woes trace back to June 30, 2013, the last time that the Debtors had positive "same store" sales. However, the Debtors' circumstances took a particularly strong turn for the worst at the end of 2015, when it was reported in their Q4 2015 financial reports (Q4 2015 Financials) that the Debtors' sales were significantly below analysts' expectations. The value of the Debtors' shares declined by approximately 33% following the release of the Q4 2015 Financials, and the Debtors replaced their CEO.

Creditors also tightened or eliminated their credit lines in response to the Q4 2015 Financials. As a result of these reductions, the Debtors were unable to maintain sufficient inventory, especially during the 2016 holiday season. This, in turn, adversely impacted the Debtors' borrowing base, resulting in a "liquidity crisis."

D&H was among the creditors that had tightened its grip on its accounts receivable with the Debtors. D&H had given the Debtors a credit limit of between $10-12 million in 2014. However, beginning in 2015, D&H began steadily decreasing that credit limit, and by January 2016, D&H had reduced the credit limit to $1 million. At the same time, from 2015 to 2016, the Debtors had substantially increased their purchases from D&H. The Debtors had purchased $20 million in product from D&H in 2015, and the Debtors increased their purchases to $28 million in 2016. In order to facilitate the Debtors' increasing supply needs in the face of a shrinking credit limit, D&H had reduced the Debtors' credit terms, set at net 60 until November 2015, to net 30 from November 2015 to February 2016, and again further reduced them to 0.25% 15, net 16 from February 2016 through the Petition Date.

It was not uncommon for D&H to seek a payment schedule or contact the Debtors regarding payment of late invoices prior to the 90-day preference period. However, the tone of the parties' communications changed closer to and within the preference period. While communications were, historically, solely between members of the Debtors' and D&H's respective credit and accounts payable departments, during the preference period, these communications often came from D&H's senior executives and were directed to (or copied) senior executives of the Debtors. Moreover, immediately prior to and during the preference period, D&H began threatening to stop deliveries in the event D&H did not receive payment or confirmation of a payment schedule from the Debtors. At trial in the *hhgregg* case, one of the Debtors' chief

executives testified that his colleague(s) who had managed the relationship with D&H "took a lot of pride" in doing so and had urged the Debtors to prioritize payments to D&H.

Despite this, D&H never actually threatened litigation or withheld any product from the Debtors, and one of the Debtors' senior vice presidents later testified at trial that he did not take seriously D&H threats to withhold product. Moreover, the timing of the Debtors' payments remained largely consistent both prior to and during the preference period. Based on evidence presented by D&H at trial, 98% of the payments during the historical period of January 3, 2015 to December 3, 2016 were made between 5 days prior to and 15 days after their applicable due dates and, during the preference period, over 95% of the payments were also made between 5 days prior to and 15 days after their applicable due dates.

On November 17, 2017, the Official Committee of Unsecured Creditors appointed in the Debtors' case (Plaintiff) filed a complaint to recover, as preferences under Bankruptcy Code Section 547, payments totaling $4,697,308.30 (Alleged Preference Payments) made by the Debtors to D&H during the 90-day period prior to the Petition Date—i.e., December 6, 2016, through March 6, 2017 (Preference Period). Notably, D&H had not filed a proof of claim in the bankruptcy case as D&H managed to obtain full payment of its claim against the Debtors prior to the Petition Date and actually owed a credit balance to the Debtors as of the Petition Date. On May 6, 2020, the Bankruptcy Court entered an order granting summary judgment in the Plaintiff's favor as to its *prima facie* case to avoid the Alleged Preference Payments under Section 547(b). The court reserved for trial the issue of whether the transfers were shielded by the subjective OCB defense.

The Bankruptcy Court's Ruling

Following trial, the Bankruptcy Court held that D&H had not proven the subjective OCB defense and ruled that D&H was liable to the Plaintiff for the transfers, in the amount of approximately $3.5 million (net of subsequent new value), plus prejudgment interest. The court noted that D&H had failed to satisfy its burden as the defendant of proving by a preponderance of the evidence that the Alleged Preference Payments had satisfied the subjective OCB defense.

In its analysis, the Bankruptcy Court noted that the subjective OCB defense is not governed by a "precise legal test." Rather, the defense generally entails using the debtor's payment history prior to the Preference Period to determine a baseline for the parties' dealings, and then comparing that baseline with the payments made during the Preference Period. The court noted that the determination of what historical period should be analyzed to establish that "baseline" must be made on a case-by-case basis—the period should be grounded in the *parties'* payment history, rather than dictated by a fixed or arbitrary cutoff date.

Here, D&H provided a statistical analysis of its payment history with the Debtors from January 3, 2015, to December 3, 2016 (i.e., just days prior to the inception of the Preference Period). Although the Bankruptcy Court acknowledged that in some cases it would be appropriate to review the entire pre-preference period history, in this instance, the court had to truncate the historical period to 13 months so as not to include the 10-month period (February 2016 through December 2016) immediately prior to the Preference Period when the Debtors had experienced a "liquidity crisis." The court relied on decisions by the U.S. Court of Appeals for the Seventh Circuit and other courts that have held that the historical baseline should be limited to a timeframe when the debtor was financially healthy, since a debtor's financial difficulties will likely have already altered its dealings with its creditors. Here, the Bankruptcy Court refused to include the period following the release of the Q4 2015 Financials in the historical "baseline" to compare with the Preference Period, since the Debtors' financial circumstances and relations with creditors, D&H included, had taken a turn for the worse following the release of the Q4 2015 Financials.

In any event, the Bankruptcy Court concluded that D&H's payment history supported D&H's subjective OCB defense. The court noted that 98% of the invoices from D&H's proposed historical period were paid between 5 days prior to and 15 days after their applicable due dates (consistent with the timing of payments made during the Preference Period) and, without any analyses provided by either party for the truncated historical period, the Bankruptcy Court assumed that percentage would "largely hold up" even with truncation. The court also found that a number of other factors weighed in favor of D&H's subjective OCB defense. For example, during the Preference Period, D&H had never (a) withheld shipments; (b) threatened to turn over the Debtors' account to collection; (c) threatened to commence litigation; or (d) sought guarantees from the Debtors' principals or officers. Moreover, D&H had increased business with the Debtors during the Preference Period when the Debtors were experiencing extreme financial distress.

> Bankruptcy Code Section 547(c) provides multiple defenses that a creditor can assert to reduce its preference exposure.

However, the court found that at least as much evidence weighed equally against D&H's subjective OCB defense. The court considered D&H's change in terms from Net 30 to .25% 15, Net 16 in February 2016, which was prompted by D&H's sharp reduction in its credit limit to $1 million in January 2016. In addition, during the Preference Period (but not during the truncated historical period), D&H included the Debtors' senior management on requests for payment of invoices and threatened to withhold deliveries. Moreover, the Debtors' employees testified that they had advocated for payments to D&H even while the Debtors were generally managing their liquidity.

The Bankruptcy Court acknowledged the decision was "not an easy call" since D&H had continued to supply the Debtors and actually increased shipments to the Debtors when the Debtors were experiencing extreme financial hardship (which is what Congress wanted to encourage when it established the OCB defense), and neither party had "noticeably tipped the scales in their favor" based on the evidence presented. Ultimately, however, it is the

defendant's burden to prove its defenses by a preponderance of the evidence—a burden the court concluded D&H had not met. The court therefore held that D&H was liable to pay $3,517,805.06, after giving credit for the new value defense D&H had proved. The court concluded that the D&H could not prove the subjective OCB defense since D&H had pressured the Debtors to fully pay D&H's claim prior to the Petition Date and D&H ended up with a credit balance on the Petition Date as a direct result of D&H's increased efforts to collect in the time period leading up to the bankruptcy filing.

Conclusion

The *hhgregg* decision illustrates just how easy it is for a creditor seeking to manage its credit risk by taking reasonable collection actions to end up negating a potential subjective OCB defense. The fact-sensitive analysis and D&H's failure to satisfy its burden of proof on the subjective OCB defense resulted in D&H facing a significant preference liability, even where its efforts to minimize its credit risk with the financially distressed Debtors seemed relatively ordinary. Of course, a prudent creditor should take steps to minimize credit risk when dealing with struggling customers. But one must wonder where the *hhgregg* decision would have landed had D&H not threatened to stop deliveries or had not directly communicated with the Debtors' executives, particularly since it seems the Debtors had largely paid its invoices on time for two years prior to the bankruptcy filing in any event. Creditors should always be careful to balance the steps taken to minimize credit risk against the risk of preference exposure down the road.

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

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

3 The Plaintiff had argued that D&H's reliance on an analysis based on the days taken to pay from the due date (a "days late" analysis) was inappropriate, and that the Court should have instead compared the interval between the invoice date and payment date (a "days-to-pay") analysis. The Court rejected this argument, agreeing—"albeit reluctantly"—with D&H that a days late analysis was more appropriate where the parties' credit terms had changed during the historical period and a review of days-to-pay from invoice date would not have yielded a reliable comparison of how promptly the Debtors had paid invoices during the period.

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