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LITIGATING BANKRUPTCY PREFERENCES WHEN NOTHING IS “ORDINARY”

The ordinary-course of business defense is intended to encourage creditors to continue to do business with debtors by shielding ordinary-course payments from avoidance and recovery. In this article, the author discusses the limits of what is defined as “ordinary” in the cases, and the disconnect it creates between bankruptcy policy and practice. She concludes with a note on the Consolidated Appropriations Act of 2021, which she finds is a partial and temporary fix.

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WHAT IS A PREFERENCE? (OR, HOW THE BANKRUPTCY CODE RUBS SALT IN CREDITORS' WOUNDS)

The avoidance and recovery of preferences are statutory causes of action that are — at least theoretically — designed to keep the debtor from preferring certain creditors over others and to ensure that similarly situated creditors are given equal treatment. In practice, the existence of the preference provisions in the Bankruptcy Code means that bankruptcy lawyers spend a great deal of time explaining to incredulous clients that not only are the clients *not* going to get paid what they are owed by the debtor, they are likely to have to return what little they did receive before the bankruptcy filing.

Section 547(b) of the Bankruptcy Code provides that a trustee¹ “may, based on reasonable due diligence in the

¹ Subject to certain limitations not relevant here, the debtor in possession in a chapter 11 case has essentially all of the rights and powers of a trustee under the Bankruptcy Code, including

circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property”² that was made to or for the benefit of a creditor on account of an antecedent debt, while the debtor was insolvent, on or within 90

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the power to avoid and recover preferences. See 11 U.S.C. § 1107(a).

² The trustee’s obligation to perform reasonable due diligence and take into account a creditor’s potential affirmative defenses is a relatively recent amendment to the Bankruptcy Code, having been added by Sec. 3 of the Small Business Reorganization Act of 2019. At least one court has found that “this condition precedent, i.e., due diligence and consideration of affirmative defenses, is an element of the trustee’s prima facie case,” and suggested that the trustee’s failure to meet such condition “may defeat jurisdiction.” *In re ECS Ref., Inc.*, 625 B.R. 425, 453–54 (Bankr. E.D. Cal. 2020).

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days before the filing of the petition,³ that gave the creditor more than it would get in a chapter 7 liquidation.⁴

Despite the requirement that the trustee undertake “reasonable due diligence” before suing creditors to recover allegedly preferential transfers,⁵ the bar to presenting a prima facie case is extremely low. Any sale of goods or provision of services on credit is “on account of antecedent debt,” and the debtor is presumed to be insolvent during the 90 days before the filing of its bankruptcy petition.⁶ Moreover, as a practical matter, a creditor that receives full payment of its invoice prior to the petition date has almost certainly received more than it would have gotten had the payment not been made and the creditor instead had to settle for whatever distribution it might get in chapter 7.

Once the trustee makes a prima facie case that a creditor has received a preference, the burden shifts to the creditor to assert one or more of the affirmative defenses set forth in the preference statute.⁷

THE ORDINARY-COURSE-OF-BUSINESS DEFENSE

Section 547(c) of the Bankruptcy Code enumerates several affirmative defenses to avoidance of a preference, the best-known of which is commonly called

the “ordinary course of business” or “OCB” defense. A trustee may not avoid a preferential transfer “to the extent that such transfer was in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was (1) made in the ordinary course of business or financial affairs of the debtor and the transferee *or* (2) made according to ordinary business terms.”⁸

The OCB defense is intended to encourage creditors to continue to do business with debtors by shielding ordinary-course payments from avoidance and recovery. As one court explained:

The ordinary-course-of-business safeguard is designed to balance the debtor's and creditor's respective interests. . . . On the one hand, the preference rule aims to ensure that creditors are treated equitably, both by deterring the failing debtor from treating preferentially its most obstreperous or demanding creditors in an effort to stave off a hard ride into bankruptcy, and by discouraging the creditors from racing to dismember the debtor. On the other hand, the ordinary course exception to the preference rule is formulated to induce creditors to continue dealing with a distressed debtor so as to kindle its chances of survival without a costly detour through, or a humiliating ending in, the sticky web of bankruptcy.⁹

³ For payments to insiders, the lookback period is one year. 11 U.S.C. § 547(b)(4)(B).

⁴ 11 U.S.C. § 547(b).

⁵ Not surprisingly given the newness of the diligence requirement, courts have not yet created clear guidelines for what constitutes “reasonable due diligence.” See, e.g., *In re Reagor-Dykes Motors, LP*, No. 18-50214-RLJ-11, 2021 WL 2546664, at *3 (Bankr. N.D. Tex. June 21, 2021).

⁶ 11 U.S.C. § 547(f).

⁷ See, e.g., *In re AppOnline.com, Inc.*, 315 B.R. 259, 272 (Bankr. E.D.N.Y. 2004) (“If the Trustee ‘puts forth sufficient proof to establish a *prima facie* preference, the burden shifts and the creditor is given the opportunity to establish by a preponderance of the evidence that one of the enumerated exceptions in 11 U.S.C. § 547(c) applies.”) (quoting *Child World, Inc. v. Service Merch. Co. (In re Child World, Inc.)*, 173 B.R. 473, 476 (Bankr.S.D.N.Y.1994)).

⁸ 11 U.S.C. § 547(c)(2) (emphasis added). Until the 2005 amendments to the Bankruptcy Code, this provision was in the conjunctive, requiring creditors to prove, by a preponderance of the evidence, that a transfer was both ordinary between the parties *and* on terms ordinary in the relevant industry. See, e.g., *Pereira v. United Parcel Serv. of Am., Inc. (In re Waterford Wedgewood)*, 508 B.R. 821, 827 (Bankr. S.D.N.Y. 2014) (“The BAPCPA Amendments made the elements for the ordinary course of business defense disjunctive, thus allowing a creditor to prove either the subjective element under section 547(c)(2)(A) or the objective element under section 547(c)(2)(B).”).

⁹ *In re Powerwave Techs., Inc.*, No. 13-10134 (MFW), 2017 WL 1373252, at *3 (Bankr. D. Del. Apr. 13, 2017) (citations omitted).

Indeed, “the very existence of § 547(c)(2)” evidences the Bankruptcy Code’s policy of promoting continuing relationships between debtors and their creditors, “relationships which if encouraged will often help businesses fend off an unwelcome voyage into the labyrinths of bankruptcy.”¹⁰ In light of this policy, you might think that a creditor’s actions to accommodate a distressed debtor — stretching payment terms, extending maturities, increasing credit limits, forbearing from stopping shipments while catch-up payments are made — would be encouraged and protected from preference attack. But (until very recently) you would be mistaken.

Although “[t]he concept of ordinary course of business arises in many contexts, [it] is not defined in the bankruptcy code.”¹¹ However, at least with respect to the first, subjective prong of the affirmative defense, the analysis is often highly mechanistic, relying on mathematical and statistical analyses rather than the contextual narrative of the actual relationship or the parties’ intent.¹² The creditor must first establish a historical baseline of dealings between it and the debtor, which is then compared to the dealings between them

during the preference period.¹³ A number of different methodologies may then be applied to assess the “ordinariness” of the challenged transfers. For example, under the range approach, the range of days-to-pay for all invoices in the historical period is compared with the range of days-to-pay during the preference period.¹⁴ The days sales outstanding (“DSO”) method “involves multiplying the total amount of an invoice by the number of days it took to be paid. That number is then divided by the total amount of the invoices in that batch,” thereby establishing a dollar-weighted average of the days outstanding for the payments received in the historical and preference periods.¹⁵ Other methods include the batch method, the inter-quartile range method, and the standard deviation method.¹⁶ All of these methods have one thing in common: they reduce ordinariness to a numbers game.

That fact becomes particularly problematic for the creditor who is asked to extend financial accommodations to a debtor, because those accommodations will inevitably result in a payment pattern that looks different from that established in the historical period. The methodologies used to analyze ordinariness cannot distinguish between changes that were made because a pushy creditor strong-armed the debtor into paying it ahead of others, and modifications that were put in place to help the debtor and try to stave off bankruptcy. In other words, when it comes to the OCB defense, no good deed goes unpunished.

¹⁰ *In re Molded Acoustical Prod., Inc.*, 18 F.3d 217, 225 (3d Cir. 1994).

¹¹ *Wilson v. First Citizens Bank*, No. C14-1842-JCC, 2015 WL 12559902, at *3 (W.D. Wash. June 10, 2015), *aff’d and remanded sub nom. First Citizens Bank & Tr. Co. v. Wilson*, 711 F. App’x 374 (9th Cir. 2017).

¹² The second, objective prong of the OCB defense is somewhat broader and more flexible, going “beyond what is normal between the debtor and creditor.” *Powerwave*, 2017 WL 1373252, at *8. “[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 the affirmative defense. *In re Molded Acoustical Prod., Inc.*, 18 F.3d 217, 220 (3d Cir. 1994). Furthermore, “the court must look to those terms employed by similarly situated debtors and creditors facing the same or similar problems. ***If the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry.***” *Wilson v. First Citizens Bank*, No. C14-1842-JCC, 2015 WL 12559902, at *5–6 (W.D. Wash. June 10, 2015), *aff’d and remanded sub nom. First Citizens Bank & Tr. Co. v. Wilson*, 711 F. App’x 374 (9th Cir. 2017) (citation omitted) (emphasis in original). However, proving the objective prong of the defense often requires a creditor to retain expert witnesses, which may be cost-prohibitive in many cases.

¹³ *Davis v. R.A. Brooks Trucking Co. (In re Quebecor World (USA), Inc.)*, 491 B.R. 379, 386 (Bankr. S.D.N.Y. 2013). There is no specific, prescribed historical time frame that must be used for the analysis, but courts generally agree that it “should encompass ‘the time period when the debtor was financially healthy.’” *Id.* at 387; *see also Moltech Power Sys. Inc. v. Tooh Dineh Indus. Inc. (In re Moltech Power Sys. Inc.)*, 327 B.R. 675, 680 (Bankr. N.D. Fla. 2005).

¹⁴ *See, e.g., Am. Home Mortg.*, 476 B.R. 124, 138 (Bankr. D. Del. 2012) *Bridge Assoc. v. C & D Marine, LLC (In re Torch Offshore, Inc.)*, Adv. No. 07–1001, 2008 WL 2475746, at *3 (Bankr. E.D. La. June 18, 2008); *Bros. Gourmet Coffees, Inc. v. Armenia Coffee Corp. (In re Bros. Gourmet Coffees, Inc.)*, 271 B.R. 456, 461 (Bankr. D. Del. 2002); *H.L. Hansen Lumber Co. of Galesburg v. G & H Custom Craft, Inc. (In re H.L. Hansen Lumber Co. of Galesburg)*, 270 B.R. 273, 278 (Bankr. C.D. Ill. 2001).

¹⁵ *Powerwave*, 2017 WL 1373252, at *6.

¹⁶ *Id.*; *see also In re LMCHH PCP, LLC*, No. 17-10353, 2020 WL 3702889, at *3 (Bankr. E.D. La. July 6, 2020).

THE CONSOLIDATED APPROPRIATIONS ACT OF 2021: A PARTIAL, TEMPORARY FIX

Congress finally acknowledged the disconnect between bankruptcy policy and practice in the Consolidated Appropriations Act of 2021, which was signed into law on December 27, 2020 and temporarily added a new section 547(j) to the Bankruptcy Code. That section bars a trustee from avoiding a transfer for a “covered payment of rental arrearages” or a “covered payment of supplier arrearages.”¹⁷ Those terms are defined as payment of arrearages made in connection with an agreement or arrangement between the debtor and its landlord or supplier, entered into on or after March 13, 2020, to defer or postpone payments under a nonresidential lease or executory contract — effectively, a forbearance agreement or “arrangement.”¹⁸ Payment of such arrearages would almost certainly fall outside of the usual OCB defense, if later challenged as a preference.

The new safe harbor for creditors comes with some significant limitations: the payment of arrearages cannot exceed amounts that were due under the lease or contract

prior to March 13, 2020, and it cannot include fees, penalties, or interest greater than the fees, penalties, or interests that the debtor would have had to pay had it not been delinquent.¹⁹ Furthermore, it only applies to agreements with nonresidential landlords and vendors — agreements with residential landlords and lenders are notably excluded, as are open-credit arrangements. And it appears to cover only repayment of arrearages that accrued prior to the declaration of the national emergency a year and a half ago (or, at least, limits protection to the same amounts that accrued prior to that time). Finally, section 547(j) is scheduled to sunset after two years, on December 27, 2022.

Section 547(j) is far from a complete solution, but it does at least recognize that sometimes payments outside of the ordinary course of business are intended to help debtors, not to prefer creditors. While the scope and usefulness of the new provision has yet to be tested in court, many practitioners anticipate that it will eventually be expanded and made permanent, thereby bringing the preference statute into closer alignment with its policy goals. ■

¹⁷ 11 U.S.C. § 547(j)(2)(A)-(B).

¹⁸ The Bankruptcy Code does not define the term “arrangement,” and to date no courts have interpreted it (or any other provision of section 547(j)). Presumably, the term is intended to capture less formal, possibly even undocumented, agreements between the debtor and creditor.

¹⁹ 11 U.S.C. § 547(j)(1). As a practical matter, this limitation effectively excludes nearly all fees, penalties, and interest, since such amounts are rarely charged with respect to timely payments.