

Chapter 1

Introduction to Preference Analyses and the Ordinary Course of Business Defense

Given the economic turmoil observed across a variety of industries in recent years, the possibility of receiving preference demand letters has been a significant concern for creditors of all types. According to § 547 of the Bankruptcy Code, after filing for bankruptcy, the trustee or debtor-in-possession may recover transfers occurring in the 90 days prior to the filing, provided the transfers meet certain criteria. Conversely, the creditor has several defenses against preference claims to retain transfers previously received.

What constitutes a preference has been the subject of many differing opinions since the passage of the Bankruptcy Reform Act of 1978. By way of example, in a 1998 ruling, the Seventh Circuit provided one definition of a preference when it wrote that a “sudden payment in full of all debts in a discrete category, in anticipation of bankruptcy and for the purpose of helping a favored class of creditors, is the paradigm of a preference.”¹

In the Jan. 4, 2012, opinion of Hon. Judge Christopher J. Sontchi of the U.S. Bankruptcy Court for the District of Delaware, a comprehensive assessment of preference law and its underpinnings was provided.² Judge Sontchi attempts to provide the reader with an economic understanding of why bankruptcy law exists and what equities it is trying to balance. He notes “[t]he basic problem that bankrupt-

1 *Modern Metal Products Co. v. Virtual Engineering Inc. (In re Modern Metal Products Co., Bankruptcy No. 08-B-73908 (Bankr. N.D. Ill April 8, 2015))* (quoting *In re Milwaukee Cheese Wisc. Inc.*, 112 F.3d 845, 847 (7th Cir. 1997)).

2 *Burtch v. Revchem Composites Inc. (In re Sierra Concrete Design Inc.)*, 463 B.R. 302 (Bankr. D. Del. 2012).

cy law is designed to address is that the system of individual creditor remedies, *i.e.* ‘first come; first served,’ may harm *creditors as a whole* when there are insufficient assets to pay all of them in full.” He goes on to discuss how preference law specifically addresses this dilemma: “Preference law enters the picture because the descent of a company into bankruptcy takes time. This allows the more diligent, individual creditor to opt-out of the compulsory, collective proceeding of bankruptcy by exercising its individual, state law remedies or, at least, by pressuring a potential debtor to pay the creditor’s claim ahead of other claims.”

Bankruptcy law attempts to address this by providing trustees and debtors-in-possession with the opportunity to recover from creditors those payments that might have been preferential, as described by Judge Sontchi. In most bankruptcies, the trustee or debtor-in-possession is permitted by law to review any payments (“transfers”) in the 90 days prior to the bankruptcy filing.³

Creditor Defenses to Preference Claims

The Bankruptcy Code provides guidance on how a debtor can assess when a payment might have been preferential, to the detriment of other creditors. As Judge Sontchi notes, this guidance requires “consideration of evidence unique to the creditor that received the preferential payment.” The exceptions that are to be

3 By definition, a preferential transfer is any “transfer” to or for the benefit of the creditor during the 90-day period counting backwards from the bankruptcy filing date. A “transfer” is anything of value, whether or not tangible, that the bankrupt debtor gave any creditor or gave up for the benefit of a creditor for any reason. According to the statute of limitations as outlined in § 546 of the Bankruptcy Code, preference actions may not be commenced after the later of (1) two years after the entry of the order for relief or (2) one year after the appointment or the election of the first trustee.

considered include the “ordinary course of business” defenses and the “subsequent new value” defense. Judge Sontchi explains that “[t]he point of these defenses is to ameliorate the over inclusive nature of the bright line rule by excluding transactions that, in all likelihood, were not the result of opt-out behavior by the creditor. Indeed, in all probability, these transactions provided a net benefit to the debtor’s business and, thus, creditors as a whole.”

The ordinary course of business defense is applicable in those circumstances where the creditor seeks to demonstrate that the transfers occurred consistent with the ordinary course (1) in the industry or (2) in the relationship between the parties. As Judge Sontchi notes, this defense corresponds with “payments that are made in the ordinary course on debts incurred in the ordinary course according to ordinary business terms.”⁴ This defense is again intended to prevent recovery by the debtor of those payments that are not the subject of potential opt-out behavior. By limiting recovery in this manner, the existence of the defense is intended to deter such opt-out behavior.

As Judge Sontchi explains, “An understanding of these basic principles is necessary to interpret the somewhat confusing preference correctly. It simply doesn’t make sense to interpret the statute in a manner that would be contrary to its fundamental purpose. When keeping these principles in mind, interpretation of the preference statute becomes much simpler.”⁵

The opinion of Judge Sontchi provides excellent guidance on the fundamental goals, purpose and economics of preference actions. It is with these fundamentals in mind that we will discuss the basics of the preference statute, the documents and information often reviewed pertaining to preference matters, and the analyses often completed in

4 *In re Sierra Concrete Design*, 463 B.R. at 304.

5 *Id.* at 306.

assessing the validity of preference claims. While there are multiple analyses that can be considered with respect to preference matters, this book will focus on issues pertaining to the ordinary course of business defense.

Ordinary Between the Parties: Subjective Test⁶

In establishing the ordinary course of business defense relating to the relationship between a debtor and creditor, the timing and method of transfers between the parties are often of primary importance. Preference period⁷ transfers are typically analyzed to establish whether they were consistent with transfers made historically. This can consider the days between payment and receipt, the terms of individual purchase orders, the method of payment and the circumstances between the parties. Often, payment abnormalities such as rejected parts, returns and cancellations can present unique circumstances that should be evaluated.

Ordinary in the Industry: Objective Test⁸

Comparisons to industry standards are often used to establish a reasonable basis for ordinary course. As stated by Scott Blakeley and Terry Callahan of the Credit Research Foundation, when establishing the industry ordinary course of business defense, “although the industry standard does not require a creditor to establish the exis-

6 Throughout this book, references to the subjective test and the subjective defense may be utilized interchangeably.

7 Throughout this book, references to the “preference period” relate to the 90 days prior to the debtor’s bankruptcy.

8 Throughout this book, references to the objective test and the objective defense may be utilized interchangeably.

tence of a uniform set of business terms, it does require evidence of a prevailing practice among similarly situated members of the industry facing the same or similar problems.”⁹ Throughout the course of this book, we will be assessing and discussing many of the factors that may impact a bankruptcy court’s ruling of whether the alleged preferential transfers occurred within the industry “ordinary course.”

Factors Often Considered by the Courts

In general, issues commonly considered by courts in determining whether the alleged preferential transfers were ordinary include, but are not limited to:

- the length of time the parties were engaged in the transactions at issue;
- whether the subject transfers were in an amount more than usually paid;
- whether the amount or form of the transfers differed from past practices;
- whether the debtor or creditor engaged in any unusual collection or payment activity; and
- whether the creditor took advantage of the debtor’s deteriorating financial condition.

If any of these factors are present, a court may find that the transfer does not qualify for an ordinary course of business defense.

9 Scott Blakeley & Terry Callahan, “In Defense of a Preference,” *The Credit Research Foundation*, 2004.

It is important to note that the ordinary course defense is considered an “or test” rather than an “and test.” That is, modifications to the bankruptcy law have provided that either ordinary course analysis can be utilized to demonstrate that a payment was not preferential. This is discussed in greater detail in Chapter 2.

Who This Book Is For

This book is written for the bankruptcy professional who is exposed to bankruptcy preference matters, whether it be in the context of assisting either a debtor or creditor. It can also be a useful resource in corporate planning to evaluate preference exposure before a customer or vendor files for bankruptcy protection. This book is not intended to be an exhaustive resource of every facet of bankruptcy preference matters that may arise. Rather, it is intended to arm the reader with sufficient understanding to be able to:

- understand the context of bankruptcy preferences;
- ask relevant and reasoned questions regarding preference analyses;
- request the information and documents that will be most helpful in analyzing potential preferences;
- understand common issues in analyzing payment data — both as prepared by the debtor or creditor as well as by common industry research sources;
- challenge assumptions from a common sense “business” perspective and play “devil’s advocate” with respect to the analysis of preference payments; and

- confirm that the assumptions and premise on which the analyses are based are consistent with the law or legal arguments of the case.

Overview of Topics Covered in the Book

As demonstrated by the framework presented below, this book starts with an overview of basic bankruptcy background as well as accounting and business basics that will assist with an understanding of the analysis of pre-bankruptcy payments. It then transitions to a more detailed discussion of the analysis of ordinary course — between the parties and in the industry.

Chapter 2 — Background: The Bankruptcy Code & The Ordinary Course of Business Defense

Chapter 3 — The Role of Accounting Systems in the Ordinary Course

Chapter 4 — The Data-Gathering Process and Assessing “Reasonably Certain”

Chapter 5 — Ordinary in the Industry (The “Objective Test”)

Chapter 6 — Ordinary Between the Parties (the “Subjective Test”)

Chapter 7 — Subsequent New Value Defense & Contemporaneous Exchange for New Value Defense

Chapter 8 — Conclusion

In addition, in each chapter we will provide a “Legal Note” in which a litigator experienced in bankruptcy preference cases will offer perspective on the chapter topic through references to the law, case examples and other insights. Finally, information on each of the authors as well as additional resources to assist in ordinary course analyses are provided in the appendices attached to this book.

Appendix A — Summary of Industry Resources

Appendix B — Common Metrics and Terms in the Analysis of Preferential Transfers

Appendix C — Listing of Noteworthy Cases