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Litigating the Ordinary Course of Business Defense – Summary Judgment and the Stanziale v. Industrial Specialists Decision

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A. Fees & Costs

Preference litigation is frequently a game of poker between a bankruptcy trustee and creditors in which the trustee begins with a significant advantage – the lawsuit. In most cases, simply filing a lawsuit ensures that the bankruptcy trustee will leverage at least a nuisance settlement out of the defendant creditor. Depending on the strengths of a creditor's defenses and the amount in dispute, those settlements may creep into the many thousands of dollars simply because settlement is cheaper than a full blown multi-day trial.

B. The Ordinary Course of Business Defense

Recently, however, courts have recognized the viability of summary judgment to adjudicate even fact intensive ordinary course of business disputes. As previously summarized on this blog:

The "ordinary course of business" defense is intended to protect ordinary trade transactions between a debtor and a creditor. Key to proving the defense is a showing that the transfers during the preference period are consistent with how transfers were made prior to the preference period. To establish an ordinary course of business defense (often called the "subjective" test), the creditor must show (i) that the transfer at issue was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and (ii) that the transfer was made in the "ordinary course" of business or financial affairs of the debtor and the transferee.

In general, when determining whether a transfer was within the parties' ordinary course of business, a court will evaluate (i) the length of time the parties were engaged in the transactions at issue; (ii) whether the amount or form of tender differed from past practices; (iii) whether the debtor or the creditor engaged in any unusual collection or payment activity; and (iv) the circumstances under which the payment was made. The most frequently analyzed term is the timing of the payments (i.e., invoice date to payment date). The court will then compare the payments made during the preference period with those made throughout the parties' historical course of dealing. Payments that took place outside the parties' normal course of dealing will be found to be "preferential" and subject to return to the debtor's estate.

Because proving the ordinary course of business defense is so fact focused, creditors often overlook summary judgment as a means of expediting a ruling on their defense. Summary judgment is, after all, unavailable if there is a "genuine dispute as to any material fact." If the parties agree to the validity of historical transaction data, however, summary judgment becomes a great option for a cost-effective fight.

***C. Stanziale v. Industrial Specialists, Inc.*: Summary Judgment on OCB**

In the *In re Conex Holdings* bankruptcy case, the trustee, Stanziale, sued to avoid and recover allegedly preferential payments made to Industrial Specialists. Industrial Specialists asserted its defenses, including an ordinary course of business defense backed by 16 months of historical transactions between it and the Debtor. After crunching the historical transaction data, which was assumed factually accurate by both parties, Stanziale and Industrial Specialists vehemently disagreed on whether the preference period transactions fell within the ordinary course of business established by the historical transactions.

Confident in its analysis, Industrial Specialists moved for summary judgment on its ordinary course of business defense. In a motion for summary judgment hearing, judges are required to review factual assertions in the light most favorable to the non-movant. As a result, movants must overcome a high standard of proof if they wish to succeed. In a preference case like *Stanziale v. Industiral Specialists* where the underlying transactions are undisputed, summary judgment is a *perfect* opportunity to obtain an expeditious and lower-cost judgment. As Judge Sontchi acknowledged in his ruling, the historical and preference period transactions are the facts. The facts are undisputed. The real issue is the application of the law—the ordinary course of business defense—to those facts. Since the only issue was how the law should be applied, Judge Sontchi determined that summary judgment was appropriate.

D. Judge Sontchi's Pro-Creditor Summary Judgment Analysis

One of the key issues in the parties' dispute was whether statistical outliers should be excluded from the historical transaction data set. Industrial Specialists argued that it should, in part because doing so would narrow the gap between the average and median days from invoice to payment between the historical and preference period transactions. By contrast, Stanziale argued that the inclusion of the alleged outliers in the analysis was necessary because they evidenced a departure from historically delayed payments to more quickly paid bills. As published in Judge Sontchi's opinion, the competing historical and preference period analysis looked like this:

	Average Days to Pay	Range of Days to Pay	Median
Historical Period (actual)	[illegible]	[illegible]	[illegible]
Historical Period (excluding outliers)	[illegible]	[illegible]	[illegible]
Preference Period	54	41-68	55

The outlier issue is aptly summed up in Judge Sontchi's opinion. "Defendant asserts that the Court should exclude four (4) payments made over 70 days after the invoice date in the Historical Period. Without the outliers, Defendant argues that the course of business between the Debtors and Defendant was the same in the Historical Period and the Preference Period." By contrast, the "Trustee responds that the above date is skewed, arguing that 12 out of 14 invoices (86%) paid in the Preference Period were paid within 55 days of the date of invoice. In contrast, only 8 out of 20 invoices (40%) paid in the Historical Period were paid within 55 days of the invoice date." The Trustee argued that the "drastic change" in the percentage of invoices paid within 55 days proved the payments accelerated during the Preference Period.

A portion of the Trustee's arguments was based on what is known as a dollar weighted days analysis. Dollar weighted days analysis is a methodology for calculating an adjusted "average transaction" by giving greater weight to when larger invoices are paid. By doing so, large, later-than-usual payments may dramatically affect a historical analysis even if they are only one of many payments. As a result, dollar weighted days analyses are typically more susceptible to the effects of outliers and generally disfavored.

Judge Sontchi, however, did not lose sight of his favorite quote about pausing before further impairing a creditor who consistently gave credit during the debtor's trying times. As he noted in an earlier *In re Conex Holdings* case:

[W]e should pause and consider carefully before further impairing a creditor whose confident, consistent, ordinary extension of trade credit has given the straitened debtor a fighting chance of sidestepping bankruptcy and continuing in business. Bankruptcy policy, as evidenced by the very existence of § 547(c)(2), is to promote such continuing relationships on level terms, relationships which if encouraged will often help businesses fend off an unwelcome voyage into the labyrinths of a bankruptcy.

Thus, instead of delving into the minutia and trying to pick the proverbial fly dung out of the pepper, Judge Sontchi looked at the big picture. What does the overall payment history look like, and was it *similar* to that of the preference period? In taking that broad approach, Judge Sontchi expressly rejected the trustee's dollar weighted days analysis. According to Sontchi, the preference period transactions were indeed *similar* to the historical period transactions, regardless of whether he utilized the creditor *or* trustee's proposed statistical analysis. As a result, Judge Sontchi granted summary judgment in favor of the defendant, Industrial Specialists.

E. Conclusion

Given the costs and time savings associated with summary judgment, preference defendants should strongly consider litigating their ordinary course of business defense if the parties disagree only on how the defense should be applied. While applicable standards in jurisdictions vary greatly, Judge Sontchi's "big picture" analysis of the ordinary course of business data suggests that similarity is sufficient for success. If the transactions in the historical and preference period are very similar, creditors should contemplate summary judgment as a means of reducing their total financial exposure.

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