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Defending Preferential Transfers: Don't Forget the "Other" Ordinary Course Defense - The Ordinary Business Terms Defense

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Abstract

When a creditor is faced with defending preferential transfer actions in a bankruptcy case, one of the least understood, and therefore least used, defenses is the so-called "ordinary business terms" defense described in Bankruptcy Code section 547(c)(2).[1] *Failure to be familiar with, and take advantage of, the ordinary business terms defense means a credit professional goes into battle lacking one weapon that might turn the tide in his or her favor.*

The ordinary business terms defense is separate and distinct from the ordinary course of business defense that causes all of us to generate spreadsheets comparing the pre-preference period to the preference period in terms of timing, amount and manner of payment. Based upon our experience and our very unscientific and unrepresentative sampling of those regularly involved with preferential transfer litigation, the ordinary business terms defense is simply not meaningfully utilized as frequently as it should be. While ordinary course of business and new value defenses receive the predominant amount of attention, the ordinary business terms defense may be just as effective. The purpose of this article is to encourage suppliers to take full advantage of the ordinary business terms defense.

Preferential Transfer Overview

The preference recovery section is set forth in Bankruptcy Code section 547(b). That section provides that a debtor or trustee in a bankruptcy case can avoid (recover) any transfer of an interest of the debtor in property (such as payments to vendors) made:

1) To or for the benefit of a creditor;
2) For or on account of an antecedent debt owed by the debtor before such transfer was made;
3) Made while the debtor was insolvent;
4) Made within 90 days before the bankruptcy is filed (or one year for insiders);

[1] *See* 11 U.S.C. § 547(c)(2).

5) That enables such creditor to receive more than such creditor would receive if:
    a. The case were a case under Chapter 7 of the Bankruptcy Code;
    b. The transfer had not been made; and
    c. Such creditor received payment of such debt to the extent provided by the provisions of the Bankruptcy Code.

The purported purpose of the preference section is twofold. First, by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during the debtor's slide into bankruptcy. The protection thus afforded the debtor supposedly enables the debtor to work its way out of a difficult financial situation through cooperation with its creditors. Second, and more important, the preference provisions supposedly facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge the payments, so that all may share equally.[2]

Burden of Proof

It is the debtor's burden to prove that a transfer is preferential and satisfies the requirements of Bankruptcy Code section 547(b). The burden then falls upon the creditor to establish one or more of the defenses to avoidance, set forth in Bankruptcy Code section 547(c). Among those defenses are the two so-called "ordinary course" defenses set forth in Bankruptcy Code section 547(c)(2).

Today's Ordinary Business Terms Defense

Under the pre-October 2005 version of Bankruptcy Code section 547(c)(2), to shield a transfer from avoidance, the recipient of a preferential transfer had to prove, by a preponderance of the evidence, that the transfer was: (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee (the so-called "subjective test"); ***and*** (C) made according to ordinary business terms (the so-called "objective test"). The ordinary course defense is narrowly construed, and a failure to prove any one of these elements doomed the entire defense.

In 2005 the Bankruptcy Code was amended in a very small, but significant way. A task force working on the 2005 Bankruptcy Code changes to the ordinary course defense had suggested an ordinary business terms defense should be enacted by Congress and employed only when there was no significant prior course of dealing between the parties. However, when enacted, the new ordinary business terms defense was given an equal footing with the ordinary course of business defense, and can be used even if the parties did have a prior course of dealing. Accordingly, beginning with bankruptcy cases filed after October 17, 2005, a transferee need only prove that the transfer was either made in the "ordinary course of business" of the debtor and transferee, ***or*** was made according to "ordinary business terms." In other words, subsections (B) and (C) now stand on their own as separate, independent defenses, whereas they had previously been

[2] The reality is closer to a "legalized shakedown," with the result often being more beneficial to the lawyers than creditors.

conjunctive elements of a single ordinary course of business defense.

It was generally thought that the new ordinary business terms defense would significantly benefit creditors in their defense of preference actions. However, that has not proven to be the case in actual application. Prior to 2005, the focus of most courts when evaluating a creditor's ordinary course defense was on the subjective test, i.e., whether the amount, timing, manner and circumstances of the transfer were consistent with pre-preference period transfers between the creditor and the debtor.[3] Courts of the time would typically let the objective, "ordinary business terms" element of the ordinary course defense slide by, so long as such terms weren't particularly unusual.

Construction of Today's Ordinary Business Terms Defense

Now that the ordinary business terms defense stands on its own as an independent defense, courts are compelled to focus specifically on whether the ordinary business terms test has been satisfied. Preference defendants, however, must vigorously pursue this defense. And as before, the burden is on the creditor to establish the ordinary business terms defense using essentially the same factors as the subjective test, but with the focus being on business terms in the relevant industry, rather than the course of business between creditor and debtor. Accordingly, in defending a transfer using the ordinary business terms defense, a creditor must (i) define the relevant industry, (ii) establish what the business practices are in that industry, and (iii) demonstrate to the court that the business relationship between the creditor and the debtor falls within business practices generally common to the industry.[4]

Courts generally agree that pre-2005 cases interpreting the requirements of the ordinary business terms defense remain good law.[5] For example, the Court of Appeals for the Ninth Circuit interprets "ordinary business terms" to mean that the payment at issue was "ordinary in relation to prevailing business standards."[6] The Ninth Circuit Court further held that "[o]nly a transaction that is so unusual or uncommon as to render it an *aberration* in the relevant industry falls outside the broad range of terms encompassed by the meaning of 'ordinary business terms.'"[7] Further, "[i]f the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry."[8]

Similarly, the Court of Appeals for the Eighth Circuit interprets "ordinary business terms" to mean "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 subsection

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[3] *See, e.g., In re Color Tile, Inc.*, 239 B.R. 872, 875 (Bankr. D. Del. 1999).
[4] *In re Patriot Seeds, Inc.*, 2010 WL 381612 (Bankr. CD. Ill. 2010).
[5] *See In re M. Fabrikant & Sons, Inc.*, 2010 WL 4622449 (Bankr. S.D.N.Y. 2010), and *In re American Camshaft Specialties, Inc*., 444 B.R. 347, 364 (Bankr. E.D. Mich. 2011) (noting that revisiting the ordinary business terms standard is not warranted post-2005 amendment where controlling precedent has been articulated in a clear and consistent manner).
[6] *In re Jan Weilert RV, Inc.*, 315 F.3d 1192, 1197 (9th Cir. 2003), quoting *In re Food Catering & Housing, Inc.*, 971 F.2d 396, 398 (9th Cir. 1992).
[7] *In re Jan Weilert RV, Inc.*, 315 F.3d at 1198.
[8] *Id*. at 1197.

(C)."[9] Further, "ordinary business terms" must include 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."[10]

A long-term business relationship with the debtor is also useful in establishing an ordinary business terms defense, and the more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more a creditor will be allowed to vary its credit terms from the industry norm, yet remain with the safe harbor of Bankruptcy Code section 547(c)(2).[11]

In short, the adoption by certain courts of a test requiring only that a creditor's business terms not be an "aberration" or "idiosyncratic" in the relevant industry greatly enhances a creditor's ability to satisfy the ordinary business terms defense. Accordingly, suppliers should emphasize this defense much more frequently in defending preferences.

Defining the Relevant Industry

Recent case authority confirms that today's ordinary business terms test focuses on whether preferential transfers are consistent with “industry norms” prevailing at the time the transfers were made. However, courts appear to approach the objective test from inconsistent perspectives, and a frequent point of controversy is "what is the relevant industry"? Some courts require a transferee to demonstrate that the transfers were consistent with the business terms prevailing within the *debtor's industry*, whereas other courts require the transferee to show that the transfers were consistent with terms prevailing in the *creditor's industry*.[12] And at least one case seems to require the transfers to be consistent with three industry standards (i.e., debtor’s industry, creditor’s industry, and business generally).[13] Courts also differ on whether any credit terms specifically tailored to companies in distress can be considered "ordinary business terms."[14] Note, this lack of a clear direction on the precise applicable industry creates risk and motivates the plaintiff/trustee to negotiate.

Generally speaking, courts will define the relevant industry by looking (i) to credit practices between suppliers to whom a debtor might reasonably turn for its inventory, and (ii) to companies with whom the debtor competes (i.e., credit practices between a creditor's competitors, and a debtor's competitors). Further, for an industry standard to be useful as a rough benchmark, the creditor should provide credit arrangements of other debtors and creditors in a similar market, preferably both geographic and product.[15]

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[9] *In re U.S.A. Inns of Eureka Springs, Arkansas, Inc.*, 9 F.3d 680, 685 (8th Cir. 1993) (emphasis added), quoting *In re Tolona Pizza Prod. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).
[10] *In re Roblin Industries, Inc.*, 78 F.3d 30 (2nd Cir. 1996).
[11] *See, e.g., In re Molded Acoustical Products, Inc.*, 18 F.3d 217, 224 (3rd Cir. 1994).
[12] *See, e.g., In re Interstate Bakeries Corp.*, 2011 WL 96815 (Bankr. W.D. Mo. 2011) (discussing divergent 8th Circuit case authority).
[13] *In re National Gas Distributors, LLC*, 346 B.R. 294 (Bankr. E.D.N.C. 2006).
[14] *See, e.g., In re Weilert R.V., Inc.*, 245 B.R. 377 (Bankr. C.D. Cal. 2000) (discussing conflicting viewpoint).
[15] *In re Gulf City Seafoods, Inc.*, 296 F.3d 363, 369-70 (5th Cir. 2002).

Establishing Industry Business Practices

Expert testimony is useful, but not necessary; to establish the prevailing terms in an industry, and lay testimony is also acceptable. Note that an "expert" is simply a person with experience in a particular industry. The majority of people reading this article are likely "experts." Through either expert or lay testimony, a defendant must provide admissible, non-hearsay testimony related to industry credit, payment and general business terms in order to support its position.[16] Employees of a defendant-transferee may testify to show the transfers were made according to "ordinary business terms." However, the witness must: 1) have specific knowledge of its competitors' practices during the preference period, and 2) have obtained the information objectively, i.e., outside of his or her subjective experiences as an employee of the creditor/defendant.[17] Such information might also be obtained from credit industry trade sources, such as Dunn & Bradstreet, Credit Research Foundation, Risk Management Association, and others. The creditor must then present evidence of its competitor's receivables and collection practices, and of the actual payment practices of the defendant's competitors' customers.

A creditor might also offer a mix of expert and lay testimony to prove the ordinary business terms defense. For example, in *In re American Home Mortgage Holdings, Inc.*, the expert for a staffing agency preference defendant provided unrefuted testimony that he had at least two other clients that were the agency's direct competitors, and that the agency's invoices and the debtor's payments were not out of the ordinary for the industry. The debtor's own chief executive officer then testified that the agency's receivable payment history with the debtor was representative of the industry.[18]

Ordinary Business Terms Defense Successes and Challenges

Like all other defenses, the defendant/transferee must provide evidence establishing the elements of the ordinary business terms defense. A lot may be learned from half-hearted attempts to properly satisfy the ordinary business terms defense. For example, the lack of competence of witnesses (whether expert or non-expert) and failure to identify the relevant industry or industries have resulted in failed attempts to utilize fully the ordinary business terms defense.[19] Further, changes to credit terms during the preference period might result in a transferee losing protection under both the ordinary course of business and the ordinary business terms defense. For example, in *In re Hechinger Investment Co. of Delaware, Inc.*,[20] a creditor made substantial, eleventh hour changes to its credit terms. Despite having a long relationship with the debtor, the court found that such a substantial change cost the creditor protection under the ordinary business terms defense.

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[16] *In re Hechinger Investment Company of Delaware, Inc.*, 298 B.R. 240, 242 (Bankr. D. Del. 2003).

[17] *In re Interstate Bakeries Corp.*, 2011 WL 96815 (Bankr. W.D. Mo. 2011) (also noting witness must have some experience outside of his or her current employment in the industry, or at least have knowledge gained from industry seminars or workshops).

[18] *In re American Home Mortgage Holdings, Inc.*, 2012 WL 2046829 (Bankr. D. Del. 2012).

[19] *See, e.g., In re Patriot Seeds Inc.*, 2010 WL 381620 (Bankr. C.D. Ill. 2010).

[20] *In re Hechinger Investment Co. of Delaware, Inc.*, 326 B.R. 282 (Bankr. D. Del. 2005).

Creditors/defendants sometimes fail to establish the definitive industry standard. In *In re U.S. Interactive, Inc.*,[21] a creditor's expert offered no basis or statistical analysis for its conclusion that the industry average was 60 days past invoice date, and failed to state affirmatively that 45, 50, or 60 days was the standard payment term in the industry.

In the *In re Globe Manufacturing Corp.* case,[22] the court determined a contractor had failed to successfully assert an ordinary business terms defense where the debtor and contractor had no prior history of dealings, and the only evidence of industry practice presented by the contractor was a "bottom line" conclusion by a non-expert witness who admitted he had no real familiarity with industry payment practices.

Similarly, in the *In re Just For Feet, Inc.* case,[23] the court found that a conclusory affidavit made by a creditor's president asserting that the creditor's business practices were consistent with unspecified billing practices in the industry was insufficient to establish an ordinary business terms defense. In this case, engagement of an expert certainly would have been more successful.

The timing of the payment received by a creditor, compared to industry standards, is especially important in determining whether a particular transfer was made according to ordinary business terms. In *In re Amarillo Mesquite Grill, Inc.*,[24] the court held that a creditor's lack of evidence of insurance industry standards regarding late premium payments was fatal to the defendant's ability to successfully assert an ordinary business terms defense. Similarly, in *In re Waccamaw's Home Place,*[25] a court found that payments made by a Chapter 11 debtor could be avoided as preferential when those payments during the preference period were on average 34 days after the invoice due date, as compared with an average delay of 10 to 25 days in the relevant industry.

Despite these rather instructive failures, there have been a number of cases in which creditors have successfully prevailed using the ordinary business terms defense. For example, in the *In re Global Tissue* case, the debtor and a supplier were in the same industry, and the supplier successfully asserted an ordinary business terms defense by producing evidence that the average length of time it took to receive payments from all of its customers, including the debtor, and by showing that the debtor's payments were within this range.[26] In *In re GS Inc.*, a creditor/supplier on a construction project established that payments it received two months after shipping product to the debtor satisfied the ordinary business terms defense where it was clear from testimony that payments in the construction business were based on a job's progress, not on counting the days from invoice, and that there was nothing unusual about the transaction which would render it outside the ordinary course of business for the industry.[27]

In another Delaware case, a debtor's parts supplier provided expert testimony that payment terms of net sixty days, as specified in its invoices to the debtor, were consistent with existing practices in the automotive parts supply industry, and established that the payments were made according

[21] *In re U.S. Interactive, Inc.,* 321 B.R. 388 (Bankr. D. Del. 2005).
[22] *In re Globe Manufacturing Corp.,* 567 F.3d 1291 (11th Cir. 2009).
[23] *In re Just For Feet, Inc.,* 375 B.R. 129 (Bankr. D. Del. 2009).
[24] *In re Amarillo Mesquite Grill, Inc.,* 355 B.R. 826 (Bankr. D. Kan. 2006).
[25] *In re Waccamaw's Home Place,* 325 B.R. 536 (Bankr. D. Del. 2005).
[26] *In re Global Tissue, L.L.C.,* 302 B.R. 808 (D. Del. 2003).
[27] *In re GS Inc.,* 352 B.R. 858 (Bankr. E.D. Ark. 2006).

to ordinary business terms.[28] In Arkansas, a creditor proved that eight prepetition transfers received from a Chapter 7 debtor fell within ordinary business terms where it was typical in the industry for customers to pay multiple invoices with a single check, and for customers to pay within 50 to 80 days after receiving invoices, as the debtor did.[29] Finally, in the *In re Safety-Kleen Corp.* bankruptcy case, even without evidence of industry norms, the court accepted a creditor's argument that the creditor, a customer of the Chapter 11 debtor, had received a refund of an overpayment, where the debtor had initiated the refund process as soon as it discovered the customer's duplicate payment and promptly issued a refund check to the customer.[30]

Finally, under rare circumstances, the creditor's own trade terms might constitute the relevant industry standard, where the alleged preferential transferee dominated the relevant industry to such an extent that its business practice constituted the industry standard, and its dealings with the debtor were consistent with its dealings with other customers.[31]

Conclusion

In summary, the ordinary business terms defense, just like the ordinary course of business and new value defenses, is a potent weapon in the creditor's arsenal when defending alleged preferential transfers. But like any defensive weapon, the creditor must be aware it exists and know how to use it effectively.

[28] *In re Hayes Lemmerz Intern., Inc.*, 339 B.R. 97 (Bankr. D. Del. 2006).
[29] *In re Meyer's Bakeries, Inc.*, 400 B.R. 701 (Bankr. W.D. Ark. 2009).
[30] *In re Safety-Kleen Corp.*, 331 B.R. 591 (Bankr. D. Del. 2005).
[31] *In re Meyer's Bakeries, Inc.*, 387 B.R. 762 (Bankr. W.D. Ark. 2008).

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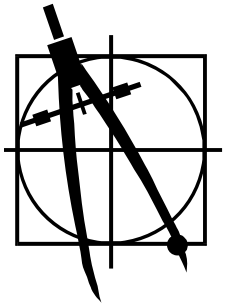

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