

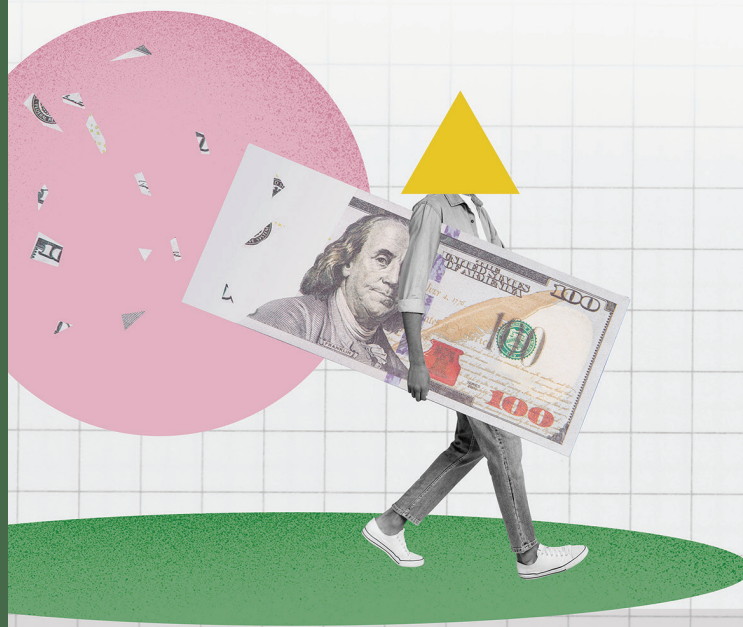
Recent Creditor Wins Based on the Objective Ordinary Course of Business Preference Defense:

HOW SWEET IT IS!

KEY POINTS

- ▶ Creditors may have to return certain payments (i.e., “preferences”) received within 90 days before a customer files for bankruptcy.
- ▶ One of the most prominent defenses against preference claims is the ordinary course of business (OCB) defense, which protects payments made in line with the parties’ historical business practices (a “subjective” OCB defense) or in accordance with ordinary industry terms (an “objective” OCB defense).
- ▶ While excessive collection pressure may impact a subjective OCB defense, recent court decisions have held that it does not affect the objective OCB defense, giving creditors more leeway when defending against preference claims.
- ▶ A recent court decision (*Center City*) also admitted expert testimony that relied on Risk Management Association data in support of the creditor’s objective OCB defense.

HALLOWEEN MAY BE OVER, BUT PREFERENCE CLAIMS CONTINUE TO HAUNT CREDITORS DEALING WITH CUSTOMERS IN BANKRUPTCY. CREDITORS FACE THE TWIN PERILS OF POTENTIALLY HAVING TO RETURN PAYMENTS THEY COLLECTED IN THE MONTHS BEFORE THE BANKRUPTCY FILING WHILE DEALING WITH UNCERTAINTY OVER WHETHER THEY’LL RECOVER THEIR OUTSTANDING CLAIMS AGAINST THE CUSTOMER.



The good news is that creditors can assert multiple defenses, including the ordinary course of business (OCB) defense, to reduce or eliminate preference liability. Read on to learn about two recent bankruptcy court decisions, in the *Center City Healthcare, LLC* and *ASPC Corp.* cases, where the creditors/preference defendants prevailed based on the objective prong of the OCB defense.

WHAT IS A PREFERENCE?

A debtor or trustee in bankruptcy can seek to recover payments made to creditors before the bankruptcy filing as a "preference" by proving the following:

1. A transfer of property of the debtor's estate (such as a debtor's payment);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (such as an outstanding invoice);
4. On or within the 90 days before the bankruptcy filing; and
5. That enables the creditor to receive more than it would in a hypothetical Chapter 7 bankruptcy case.

The legislative purpose of the preference statute is to treat creditors fairly, by giving a bankruptcy trustee or other estate fiduciary the ability to recover prepetition payments made to "preferred" creditors so that the recovered

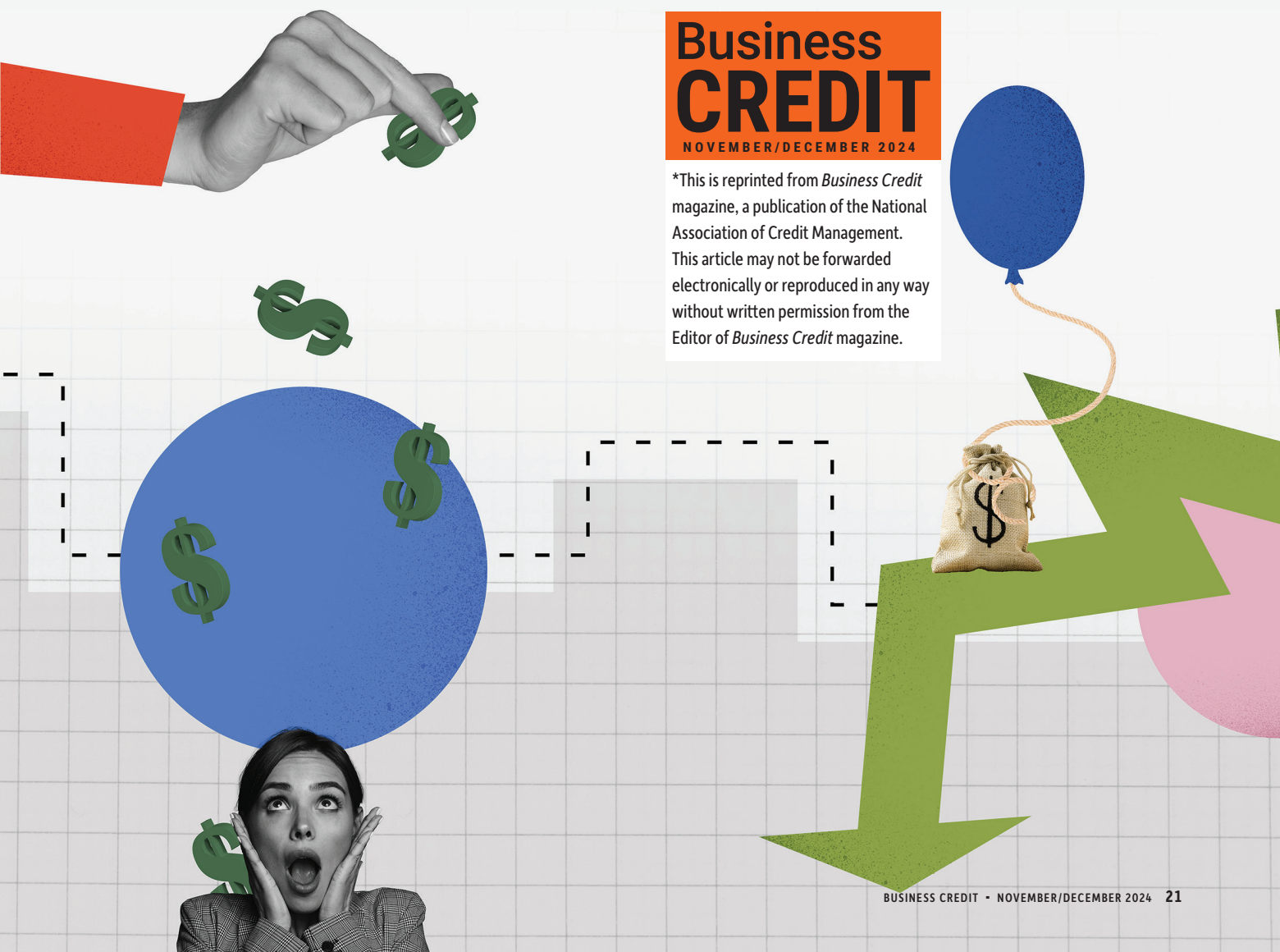
proceeds can be distributed equally among all similarly-classified creditors (in theory, at least). But to the creditor that is the target of a preference claim, the process is anything but fair. This is particularly true where preference recoveries are used to fund the administrative expenses that accrued during the bankruptcy case.

WHAT IS THE OCB DEFENSE?

There are multiple affirmative defenses that creditors can assert to reduce or eliminate preference exposure. These defenses are intended to encourage creditors to (or, reward creditors that) continue doing business with, and extending credit to, financially distressed companies heading toward a potential bankruptcy filing.

One of the most prominent defenses is the "ordinary course of business" or "OCB" defense found in section 547(c)(2) of the Bankruptcy Code. A creditor-defendant proves the OCB defense by showing that:

1. The preference payment satisfied a debt incurred by the debtor in the ordinary course of business between the parties, and
2. The payment was made either:
 - (A) in the ordinary course of business or financial affairs between the parties (the "subjective" prong of the OCB defense); or
 - (B) according to ordinary business terms (the "objective" prong of the OCB defense).



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Creditors prove the **subjective** OCB defense by showing consistency in the timing and manner of the debtor's payments during, and before, the 90-day preference period. However, the subjective OCB defense could be lost if the trustee proves that the creditor had applied unusual "collection pressure" on the debtor during the preference period, since that pressure would have arguably induced the debtor to make the alleged preference payments (i.e., the payments were not made in the ordinary course of business). Examples of collection pressure include:

- Changing credit terms
- Imposing or enforcing credit limits
- Threatening to stop shipment
- Imposing credit holds
- A creditor's change in invoice method (electronic vs. paper)
- Change in:
 - Payment method (regular check to wire, ACH, etc.)
 - Delivery method (regular mail to Federal Express or hand delivery)

Creditors prove the **objective** OCB defense by presenting evidence that the alleged preference payments were consistent with the 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 United States Bankruptcy Court in Delaware, in the *Center City* case, and the United States Bankruptcy Court for the Southern District of Ohio, in the *ASPC* case, granted summary judgment in defendants' favor based

on the objective OCB defense. Both courts followed the majority rule that relies on practices and terms in the creditor's industry in determining the applicability of the objective OCB defense, and disregarded the defendants' prepetition collection pressure on the debtors in reaching their decisions.

THE CENTER CITY DECISION

In *Center City*, the Chapter 11 debtors sought to recover over \$4 million in payments made to one of their suppliers during the 90 days before the bankruptcy filing (i.e., the "preference period").¹ The defendant moved for summary judgment seeking a ruling in its favor on the preference complaint, relying in part on the objective OCB defense.² The defendant presented expert testimony that utilized data from Risk Management Association (RMA) covering the defendant's industry, Medical, Dental and Hospital Equipment and Supplies Merchant Wholesalers, consisting of 13 companies, to prove the objective OCB defense. In response, the debtors argued that:

- The RMA data was inadmissible hearsay and, even if it was admissible, the data was insufficient because it did not consider a significant enough sample size of potentially relevant companies and industries; and
- In any event, the defendant's objective OCB defense should be rejected because the defendant had exerted "extraordinary" collection pressure during the preference period. The Debtors argued that the parties never had any "ordinary course of business" dealings, since the defendant had imposed onerous terms on the debtors due to concerns over the debtors' financial condition and engaged in extraordinary collection practices by consistently enforcing the credit limit during the preference period.

The bankruptcy court granted summary judgment for the defendant based on the objective OCB defense and subsequent new value defense. The court held that the RMA data was admissible as a market report or similar commercial publication, and the defendant does not need to prove the existence of some single, uniform set of industry-wide credit terms. The court concluded that the RMA industry category upon which the defendant's expert had relied sufficiently described the defendant's industry. And the court found the RMA data to be a compilation of "days to pay" that was obtained from information RMA had gathered from companies in defendant's industry. The court also relied on the declaration of the defendant's Director of Credit that he and others in the defendant's industry routinely use RMA data in determining credit terms. Finally, the court noted that other courts have routinely admitted expert testimony that relied on RMA data in determining ordinary business terms in various industries.

The bankruptcy court also agreed with the defendant that collection activity, even if extraordinary or unusual, is simply not relevant to the objective OCB defense. The court noted that the debtors had provided no authority that requires the court to consider collection pressure when solely considering the objective prong of the OCB defense. The court held that the defendant had proven its objective OCB defense under section 547(c)(2) of the Bankruptcy Code by presenting evidence that the parties had acted consistently with the ordinary course of business dealings in defendant's industry.

The Debtors have appealed the bankruptcy court's ruling, so this litigation is far from over.

THE ASPC DECISION

In *ASPC*, the trustee of a creditor trust formed under the debtor's Chapter 11 plan sought to recover over \$3 million in preference period payments made to one of the debtor's wholesalers. Just as in *Center City*, the defendant moved for summary judgment based largely on the objective OCB defense. In response, the trustee argued that the defendant's objective OCB defense was flawed because the defendant's expert had evaluated the wrong industry and failed to account for the fact that the defendant had reduced the debtor's credit limit during the preference period. The trustee argued, without providing any relevant evidence of its own, that the defendant's reduction of the debtor's credit limit should have been compared to how other companies in the relevant industry adjust credit limits in response to their customers' financial distress.

The bankruptcy court held that the creditor had properly relied on the creditor's industry in proving its objective OCB defense. The court stated that "creditors have considerable latitude in defining what the relevant industry is." The court also agreed with the defendant's analysis showing a consistency of the days to pay the defendant's invoices during the preference period with the range of days to pay in the defendant's industry. Finally, the court rejected the notion that the defendant's reduction of its credit limit during the preference period negated the defendant's objective OCB defense. The bankruptcy court relied on precedent from the U.S. Court of Appeals for the Sixth Circuit, in which the Sixth Circuit stated that, for the purpose of proving that payments were made according to ordinary business terms, "it would be sufficient to prove that a certain percentage of customers pay within a certain number of days after the due date." The bankruptcy court also noted that the information necessary to conduct an analysis of changes in credit limits simply is not readily available; companies are often unwilling to publicly disclose that information, making it virtually impossible to conduct that analysis.

CONCLUSION

The rulings in *Center City* and *ASPC* are huge wins for trade creditors. The decisions may help limit the potential impact of a creditor's prepetition collection pressure on that creditor's defenses to preference liability. Regardless, creditors should always be mindful of the adverse implications their collection efforts may have on the availability of the subjective OCB defense when dealing with a financially distressed customer. **BC**

1. *The Debtors also asserted a fraudulent transfer claim under section 548 of the Bankruptcy Code, which the Bankruptcy Court dismissed since the payments at issue were on account of antecedent debts and, therefore, were made for "reasonably equivalent value."*

2. *The defendant in Center City also asserted a significant subsequent new value defense that the bankruptcy court relied on in granting summary judgment in the defendant's favor.*



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