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By Bruce S. Nathan and Scott Cargill

Recent Trade Creditor Victories on the Objective Ordinary-Course-of-Business Preference Defense

Bruce S. Nathan
Lowenstein Sandler LLP
New York

Scott Cargill
Lowenstein Sandler LLP
Roseland, N.J.

Bruce Nathan is a partner in Lowenstein Sandler LLP's Bankruptcy, Financial Reorganization and Creditors' Rights Group in New York and a past member of ABI's Board of Directors. Scott Cargill is Of Counsel in the firm's Roseland, N.J., office.

The U.S. Bankruptcy Court for the District of Delaware recently granted a preference defendant's motion for summary judgment based in part on the objective element of the ordinary-course-of-business defense, with potentially far-reaching implications for preference defendants. As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amendments to the Bankruptcy Code, creditors gained a significant advantage in defending preference claims. Pre-BAPCPA, preference defendants seeking to prove the ordinary-course-of-business defense under § 547(c)(2) of the Bankruptcy Code had to satisfy *both* the subjective *and* the objective elements of the defense. The BAPCPA amendments to § 547(c)(2) made it easier for preference defendants to prove the ordinary-course-of-business defense by satisfying *either* the subjective *or* objective elements of the defense.

The bankruptcy court's August 2024 decision in *Center City Healthcare LLC v. Medline Indus. Inc. (In re Center City Healthcare LLC)*[1] discusses the evidence that a creditor must present to successfully assert an objective ordinary-course-of-business defense. Noteworthy is the court's holding that any evidence of a creditor's/defendant's extraordinary or unusual collection actions during the preference period is irrelevant to determining the applicability of the defense. Just a few months before the *Center City Healthcare* decision, the U.S. Bankruptcy Court for the Southern District of Ohio in *ASPC Creditor Trust v. Sturm Ruger & Co. Inc. (In re ASPC Corp.)*,[2] relying on very similar reasoning, also granted the preference defendant's motion for summary judgment based on the objective ordinary-course-of-business defense.

Preference Claims and the Ordinary-Course Defense

A bankruptcy trustee can avoid and recover a preferential payment or other transfer under § 547(b) of the Bankruptcy Code. The factors that would need to be proven include the following: (1) the debtor transferred its property to or for the benefit of a creditor; (2) the transfer was made on account of antecedent or existing debt that the debtor owed the creditor; (3) the transfer was made when the debtor was insolvent, based on a balance-sheet definition of liabilities exceeding assets, which is presumed during the 90-day period prior to the debtor's bankruptcy filing date; (4) the transfer was made during the 90-day preference period with respect to a transfer to a noninsider creditor of the debtor, such as a trade creditor; and (5) the transfer enabled the creditor to receive more than the creditor would have received in a chapter 7 liquidation of the debtor's assets.

Once a trustee has proven all of these elements of a preference claim, a creditor then has the burden of proving one or more of the preference defenses contained in § 547(c) to reduce or eliminate its preference liability. The ordinary-course-of-business defense, contained in § 547(c)(2), is one such preference defense. Section 547(c)(2) states:

> The trustee may not avoid under this section a transfer ... to the extent that such transfer 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 such transfer was —

1 2024 WL 3956093 (Bankr. D. Del. Aug. 27, 2024).
2 658 B.R. 455 (Bankr. S.D. Ohio 2024).

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*

(B) made according to ordinary business terms.[3]

The two types of ordinary-course-of-business defenses — the objective and subjective tests — are related, but provide different means for creditors to reduce preference liability. The objective ordinary-course-of-business test analyzes the transfers at issue based on terms used in general practice within the applicable industry.[4] By comparison, the subjective ordinary-course-of-business test reviews the challenged transfers in the context of the historical business practices between the debtor and defendant/creditor. The objective component was at issue in *Center City Healthcare*.

Facts of the *Center City Healthcare* Case

In June and July 2019, Center City Healthcare LLC and its affiliated debtors (collectively, the "debtors") filed chapter 11 cases.[5] The debtors operated St. Christopher's Hospital for Children, Hahnemann University Hospital and several affiliated physician practice groups in Philadelphia. Medline Industries Inc., one of the debtors' largest suppliers, sent invoices or statements on account of goods and services that were sold and delivered to the debtors prior to the chapter 11 filing.[6]

The debtors commenced an adversary proceeding against Medline seeking to avoid and recover the debtors' payments in the amount of approximately $4.39 million (the "transfers") to Medline during the 90-day preference period. Medline did not contest that the debtors had satisfied the *prima facie* elements of a preference claim. Rather, Medline moved for summary judgment, arguing that approximately $1.3 million of the transfers was subject to the objective ordinary-course-of-business defense, and the remaining amount was shielded from avoidance and recovery by the subsequent new-value defense.[7]

Medline submitted its expert witness's declaration to support its motion for summary judgment, relying in part on Medline's objective ordinary-course-of-business defense.[8] This declaration compared the range of the number of days it took for the debtors to pay Medline's invoices during the preference period with the number of days that it took for customers to pay companies in Medline's industry, which included medical, dental and hospital equipment, and suppliers' merchant wholesalers.

The expert reviewed Medline's business records and payment-collection information to determine the number of days that it took the debtors to pay Medline's invoices. Compiled data was reviewed by the Risk Management Association (RMA) for Medline's industry to determine the range of the number of days that it took customers to pay companies comparable to Medline in its industry. Specifically, Medline's expert used the RMA data to conclude that the range of days to pay for the invoices of 13 comparable companies was 28-76 days. The expert concluded that approximately $1.3 million of Medline's invoices paid by the transfers fell within that same payment range.[9]

Challenge to Admissibility of the RMA Data

The debtors challenged Medline's use of the RMA data as inadmissible hearsay because it was "raw data" obtained from companies in the industry,[10] but acknowledged that an expert may in, some instances, rely on hearsay evidence to formulate an expert opinion. However, the debtors argued that the RMA data was inadmissible because Medline's expert did not perform an analysis of the RMA data and instead simply reviewed the data that companies had submitted to RMA to determine the days-to-pay range in the industry.[11]

The bankruptcy court rejected the debtors' arguments and held that the RMA data was admissible as an exception to the hearsay rule as permitted for "Market Reports and Similar Commercial Publications."[12] The court concluded that the RMA data was a compilation of days-to-pay data from companies in Medline's industry and thus fell squarely within the hearsay exception. In addition, the court relied on the uncontested declaration of Medline's director of credit, which stated that he and others in the industry routinely use RMA data to set credit terms.[13]

Finally, the bankruptcy court noted that other courts had "routinely admitted testimony from experts who relied on RMA data in determining the ordinary repayment terms in various industries," thus demonstrating that such data is generally accepted.[14] The court distinguished the decision in *In re AES Thames LLC* that the debtors had relied on to argue that the RMA data was inadmissible hearsay. The court explained that the *AES Thames* court did not exclude RMA data as hearsay, but instead refused to admit information that the defendant's attorney had obtained by calling other companies in the industry, which did not qualify under the business-records-hearsay exception.[15]

Challenges to the Reliability of Medline Expert's Methodology

The debtors also challenged the use of Medline's expert's testimony on the basis that it failed to satisfy the requirements of Rule 702 of the Federal Rules of Evidence (FRE). FRE 702 states that expert testimony must show that it is more likely than not that (1) the expert's scientific, technical or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

3 11 U.S.C. § 547(c)(2) (emphasis added).

4 *See, e.g., Fiber Lite Corp. v. Molded Acoustical Prods. Inc. (In re Molded Acoustical Prods. Inc.)*, 18 F.3d 217, 220 (3d Cir. 1994); *Miller v. Florida Mining and Materials (In re A.W. & Assocs. Inc.)*, 136 F.3d 1439, 1443 (11th Cir. 1998); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

5 *Ctr. City Healthcare*, 2024 WL 3956093 at *1.

6 *Id.*

7 *Id.*

8 Medline's expert also submitted an analysis in support of Medline's new-value defense. *Id.* at *7.

9 *Id.* at *3.

10 *Id.*

11 *Id.*

12 *Id.* at *3-*4; *see also* Fed. R. Evid. 803(17) ("The following are not excluded by the rule against hearsay, regardless of whether the declarant is available as a witness ... Market Reports and Similar Commercial Publications [and m]arket quotations, lists, directories, or other compilations that are generally relied on by the public or by persons in particular occupations.").

13 *Ctr. City Healthcare*, 2024 WL 3956093 at *4.

14 *Id. See Dietz v. Jacobs*, 2014 WL 1153502, at *4 (D. Minn. March 21, 2014); *Caruso v. John Wiley & Sons Inc. (In re ITT Educ. Servs. Inc.)*, 2021 WL 933984, at *9 (Bankr. D. Ind. March 11, 2021); *Forman v. P&M Brick LLC (In re AES Thames LLC)*, 2016 WL 11595116, at *8-*9 (Bankr. D. Del. Oct. 28, 2016).

15 *Ctr. City Healthcare*, 2024 WL 3956093 at *4.

(2) the testimony is based on sufficient facts or data; (3) the testimony is the product of reliable principles and methods; and (4) the expert's opinion reflects a reliable application of the principles and methods to the facts of the case.[16]

The debtors argued that Medline's expert had failed to provide sufficient expert testimony to prove the objective ordinary-course-of-business defense because the expert neither determined the appropriate industry nor performed an analysis of the RMA data to determine the range of days to pay in the industry. Instead, the debtors argued that Medline's expert just confirmed that the debtors' payments to Medline were consistent with the industry range of payment terms contained in the RMA data.[17]

Relying on *AES Thames*, the debtors argued that Medline's expert was required to review payment data from hundreds of potentially comparable companies from various industries, develop an average statistical payment range for the sample companies, and exclude outlying data points.[18] Medline responded that its expert was entitled to rely on RMA data to establish industry credit terms, which would be consistent with the *AES Thames* holding.[19]

The bankruptcy court found that Medline's expert was reliable and rejected the debtors' contention that Medline's expert had failed to perform an in-depth analysis of the RMA data. Relying on *Molded Acoustical Prods.*,[20] the bankruptcy court stated that "the standard for determining ordinary business terms, 'though still requiring that the creditors make some showing of an industry standard, is quite accommodating.'"[21] Applying the Third Circuit's "accommodating and flexible approach," the bankruptcy court noted that Medline's expert's use of the RMA data to establish the industry range of "days to pay" without further analysis satisfied FRE 702.[22]

The bankruptcy court concluded that the RMA data, designated as "Medical, Dental, and Hospital Equipment and Supplies Merchant Wholesalers," clearly described Medline's industry, and this fact was not contested by the debtors' expert.[23] It distinguished this case from *AES Thames*, where the bankruptcy court found that three different industry categories were used because there was no RMA data directly applicable to the debtor's industry.[24] The bottom line is that the court ruled that evidence submitted by the debtors was insufficient to establish any genuine issue of material fact concerning the reliability of Medline's expert's testimony.[25]

Extraordinary Collection Efforts Are Irrelevant to the Objective Test

The debtors finally argued that the bankruptcy court must examine the relationship and behavior between the debtors and Medline before and during the preference period, including Medline's "extraordinary" collection efforts, and consider whether it was in the ordinary course of business. The debtors asserted that an objective ordinary-course-of-business defense "should be rejected where collection efforts are so extreme or unusual as to offend the principles underlying the preference statute."[26] The court agreed with Medline that any evidence of its collection activity, even if extraordinary or unusual, is not relevant for analyzing the objective ordinary-course-of-business defense.[27]

The bankruptcy court concluded that Medline and its expert were able to prove the applicability of the objective ordinary-course-of-business defense to approximately $1.3 million of the transfers at issue, and that there were no disputed issues of material fact.[28] Separately, the court concluded that Medline's asserted new-value defense was sufficient to eliminate any remaining liability to Medline for the balance of the transfers and granted Medline's summary-judgment motion in full.[29] The debtor has appealed the bankruptcy court's decision to the U.S. District Court for the District of Delaware for review, and the appeal remains pending.

The *ASPC Corp.* Case

The *Center City Healthcare* decision is consistent with the March 2024 decision in *In re ASPC Corp.*, which also granted summary judgment in the defendant's favor based on the objective element of the ordinary-course-of-business defense.[30] The *ASPC Corp.* court relied on the defendant's analysis showing a consistency in the number of days that it took for the debtors to pay the defendant's invoices with the days to pay invoices of companies in the defendant's industry.[31] The court also did not need to consider any changes in business terms between the debtor and creditor during the preference period in determining the applicability of the objective element of the defense. The defendant's reduction of the debtors' credit limit during the preference period did not result in the loss of the defense, the court held.[32]

Conclusion

The decisions in the *Center City Healthcare* and *ASPC Corp.* are great news for trade creditors seeking to defend against preference liability. However, given the pending appeal of the *Center City Healthcare* decision, creditors should be cognizant of the difficulties in proving the ordinary-course-of-business defense. abi

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16 *Id.*; Fed. R. Evid. 702.
17 *Ctr. City Healthcare*, 2024 WL 3956093 at *4.
18 *See id.* at *5.
19 *See id.*
20 18 F.3d at 224.
21 *Ctr. City Healthcare*, 2024 WL 3956093 at *5 (quoting *Molded Acoustical Prods.*, 18 F.3d at 224).
22 *Id.*
23 *Id.*
24 *See id.*
25 *See id.* at *6.
26 *Id.*
27 *Id.* at *7.
28 *See id.* at *6.
29 *See id.* at *9-*10.
30 *See id.* at 470.
31 *See id.*
32 *See id.*