"And" to "Or" Means Preference No More: The Expansion of the "Ordinary Course" Bankruptcy Preference Defense

By Scott A. Wolfson

Being sued to recover a preference can drive home the financial impact of bankruptcy to a creditor client. In addition to the loss the creditor will likely sustain on the amounts owed by the debtor when the debtor filed for bankruptcy, the creditor may be forced to return any preferential payments it received before the bankruptcy. There are several defenses to a preference action, the most common of which is the "ordinary course of business" defense.[1] Congress changed only one word of the elements of this defense—substituting an "and" for an "or"—in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] (the "Reform Act"), its recent amendments to the Bankruptcy Code.[3] That change, however, should significantly help the typical unsecured creditor defeat a preference claim.

Definition of a "Preference" and Purposes of Avoidance

Preferences are payments that favor certain creditors over others.[4] A debtor, or the trustee of a debtor, may avoid any transfer[5] of an interest of the debtor in property:

> (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—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider;[6] and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[7]

Outside the confines of bankruptcy, a company is generally free to pay its creditors in any order of priority. For example, if a company owes unsecured creditors A, B, and C $100 each, the company could pay C in full before paying any amount to A or B. However, if the company were to subsequently file for bankruptcy, transfers meeting the elements set forth above could be set aside. A preferential payment that is avoided becomes part of the common pool of assets, known as the "bankruptcy estate,"[8] for distribution to creditors under the Bankruptcy Code's priority scheme.[9]

Congress described the purpose of the preference-avoidance power as twofold: first, to discourage creditors "from racing to the courthouse to dismember the debtor during [its] slide into bankruptcy;"[10] and second, to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."[11] Thus, if the $100 payment to C constituted a preference, the debtor could recover the $100 from C for distribution pro rata to A, B, and C.[12]

Defenses to Preferences

Section 547(c) of the Bankruptcy Code excepts certain transfers from being avoided as preferences even though they meet all of the elements of a preference under section 547(b). The exceptions include payments in the ordinary course of business;[13] contemporaneous exchanges for new value;[14] purchase money security interests, or "enabling loans;"[15] and preferences subsequently offset by unsecured credit, or "new value."[16] The ordinary

course of business defense, already the most common preference defense, should become even more prevalent with the Reform Act.

Ordinary Course of Business Defense

The legislative history behind the ordinary course of business defense states that its purpose "is to leave undisturbed normal financing relations because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or [its] creditors during the debtor's slide into bankruptcy."[17] The defense, as amended by the Reform Act, provides that a transfer may not be avoided

> 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—
>
> (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.[18]

The Reform Act's one-word change significantly relaxes the standard for a transfer to be considered ordinary course because a transfer now need only be subjectively or objectively ordinary course to qualify for the defense.

Like prior law, the Reform Act continues the requirement that the debt be incurred in the ordinary course of business of the debtor and the transferee. However, the amended language now stipulates that the requirements of *either* subsection (A) *or* subsection (B) be met. Courts have interpreted the requirements of (A) to be a subjective test—i.e., that the transfer be ordinary in relation to the other business dealings between *that* creditor and *that* debtor. Courts have interpreted the requirements of (B) to be an objective test—i.e., that the transfer be ordinary in relation to the prevailing standards in the relevant industry.[19] Prior to the Reform Act, the ordinary-course defense was written in the conjunctive; a creditor had to show that the transaction was ordinary *both* subjectively and objectively.[20] The Reform Act's one-word change significantly relaxes the standard for a transfer to be considered ordinary course because a transfer now need only be subjectively *or* objectively ordinary course to qualify for the defense.

The Reform Act's changes to the ordinary-course defense apply to bankruptcy cases commenced on or after October 17, 2005. Thus, conduct today will be subject to the amended statute.

Examples of the Amendment's Potential Benefits to Creditors

Tightening Credit to Industry Standards

A company's financial problems are sometimes well known, and some bankruptcies are highly anticipated. In such circumstances, diligent creditors typically begin to shorten the time within which they require payments from the financially troubled debtor to avoid a large outstanding receivable upon a bankruptcy filing. However, there are circumstances under the new ordinary-course defense in which the creditor's demand for an earlier payment may not be considered a preference. This would be true where the new, shorter payment terms, although not subjectively ordinary course between the creditor and the company, are ordinary course in the industry. This result seems contrary to the congressionally espoused purpose of the ordinary course of business preference defense of maintaining "normal financing relations," but it appears to be required by the unambiguous language of the statute.[21] Furthermore, a creditor could argue that a change in terms to allow the creditor to be paid in line with its industry peers furthers the preference policy of equality of distribution.

For example, Creditor supplies BrokeCo. with goods under a contract that gives BrokeCo. 60 days to pay—a more generous payment term than the 30-day industry standard. Creditor then learns of BrokeCo.'s financial problems, deems itself insecure, and begins requiring payment within 30 days. BrokeCo. files for bankruptcy several months after this.

Assume that during the 90-day preference period preceding BrokeCo.'s bankruptcy Creditor received payments from BrokeCo. an average of 33 days after invoice, 30 days sooner than the average 63 days within which Creditor had received payment from BrokeCo. before the preference period. BrokeCo., or the trustee representing BrokeCo. in bankruptcy, then sues Creditor to recover as preferential the payments made during the 90 days preceding BrokeCo.'s bankruptcy.

The expedited payments would likely be preferential under the old law because the payments were not *subjectively* ordinary course—that is, not ordinary course between BrokeCo. and Creditor. The fact that the 33-day payment terms are *objectively* ordinary course—that is, standard in the industry—would not be dispositive. However, under the new law these payments should not be

preferential because they meet the objective standard.

Tightening Credit Early to Establish a Course of Dealing

The changes to the ordinary-course defense may also encourage getting tough early with a problem customer. Under the new law, any payment terms, regardless of how onerous or in line with industry standards, would appear to insulate a creditor from preference exposure provided they have been in existence long enough to be deemed subjectively ordinary course between the creditor and potential debtor.[22]

For example, what if Creditor had been more aggressive with BrokeCo. and required cash on delivery or net immediate payment terms and BrokeCo. did not file for bankruptcy until 18 months later? In that case, Creditor should have a valid ordinary course of business defense under the new law because the immediate payment terms, in effect for a year and a half, were subjectively ordinary course.[23] This is true despite the fact that Creditor obtained payment over 30 days earlier than is standard in the industry, which would have proved fatal pre-Reform Act,[24] because the Reform Act eliminates the objective component. This result is also contrary to the preference law's intention of encouraging creditors to work with a struggling company to perhaps make a bankruptcy filing unnecessary. The new law is clear, however, on the fact that payments made to a creditor in the ordinary course of *its* business with the debtor are protected.

Conclusion

The recent one-word change to the ordinary course of business defense to a bankruptcy preference action significantly expands the defense's utility to the typical unsecured creditor. Attorneys must understand the new law to properly advise a client whose customer may file for bankruptcy or to advise a client who is a defendant in a preference lawsuit.

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NOTES

1. "The most commonly raised defense by far, to the surprise of no one, is the ordinary course of business defense under § 547(c)(2) (73.4 percent)." ABI Preference Survey, *Bankruptcy Reform Study Project,* Task Force on Preferences, American Bankruptcy Institute (1997).

2. Pub L No 109-8, 119 Stat. 23 (2005).

3. 11 USC 101-1532.

4. "In general, a 'preference' exists when a debtor makes payment or other transfer to a certain creditor or creditors, and not to others. Such favoritism is prohibited by 11 USC 547(b) when a debtor is in bankruptcy." *Kenan v Fort Worth Pipe Co (In re George Rodman, Inc),* 792 F2d 125, 127 (10th Cir 1986) (citation omitted).

5. A "transfer" is broadly defined by the Bankruptcy Code as "(A) the creation of a lien; (B) the retention of title as a security interest; (C) the foreclosure of a debtor's equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property." 11 USC 101(54).

6. See 11 USC 101(31) for the definition of an "insider."

7. 11 USC 547(b) (citations omitted).

8. See 11 USC 541 for a description of assets that constitute a bankruptcy estate.

9. *See* 11 USC 507.

10. HR Rep No 95-595 at 177 (1977), *as reprinted in* 1978 USCCAN 5963; *see also In re Tolona Pizza Prods Corp,* 3 F3d 1029, 1032 (7th Cir 1993): "Unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable."

11. HR Rep 95-595 at 177-78 (1977), *as reprinted in* 1978 USCCAN 5963; *see also Warsco v Preferred Technical Group,* 258 F3d 557, 564 (7th Cir 2001) ("[T]rustee's power to avoid preferential transfers is designed to further the Bankruptcy Code's central policy of equality of distribution: 'Creditors of equal priority should receive pro rata shares of the debtor's property.'") (*quoting Begier v IRS,* 496 US 53, 58 (1990)).

12. Assuming, simplistically, that A, B, and C are the only creditors of the debtor and that there are no administrative expenses.

13. 11 USC 547(c)(2).

14. 11 USC 547(c)(1).

15. 11 USC 547(c)(3).

16. 11 USC 547(c)(4).

17. HR Rep No 95-595 at 373-74 (1977), *as reprinted in* 1978 USCCAN 5963.

18. 11 USC 547(c)(2) (emphasis denotes new language).

19. *See, eg, In re Fred Hawes Org Inc,* 957 F2d 239, 244 (6th Cir 1992).

20. *Id.* at 243-44, 245.

21. "[I]n all cases involving statutory construction, our starting point must be the language employed by Congress . . . and we assume that the legislative purpose is expressed by the ordinary meaning of the words used." *INS v Phinpathya,* 464 US 183, 189 (1984) (interpreting a statute according to its "plain meaning . . . however severe the consequences") (internal quotations and citations omitted).

22. There is no precise legal test to determine whether payments are subjectively ordinary course between parties; rather, courts "engage in a fact-specific analysis."

Fred Hawes, 957 F2d at 244.

23. The risk is that the debtor may file for bankruptcy before a new course of dealing can be established, in which case the shorter payment terms would not meet the subjective component of the ordinary-course defense.

24. *See, eg, Cage v Wyo-Ben, Inc (In re Ramba, Inc)*, No 04-20752, 2006 US App LEXIS 1653 at *14 (5th Cir Jan 23, 2006) (pre-Reform Act decision vacating finding of ordinary-course defense where court considered only payment history between the parties and failed to address whether payments were "out of line with what others do").

Scott A. Wolfson is a partner with Honigman Miller Schwartz and Cohn LLP, Detroit, where his practice focuses on commercial litigation, creditors' rights issues, and loan workouts. Mr. Wolfson has represented lenders, debtors and trustees, unsecured creditors' committees, and landlords, including financial institutions, automotive manufacturers, and tier-one automotive suppliers. He also has advised secured creditors on all aspects of loan workouts and restructurings, including creditors' rights representation. Mr. Wolfson is a member of the State Bar of Michigan Representative Assembly, the Federal Bar Association's Eastern District of Michigan Chapter, and the American Bankruptcy Institute.