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The "Ordinary Course of Business" Defense Post-BAPCPA

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The implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) resulted in certain subtle but significant changes related to preference litigation. The avoidance of preferential transfers ("preferences") is generally governed by §547 of the Bankruptcy Code.² The "minor" changes to the provisions of §547 are likely to have a significant impact on preference litigation.

Although only about half a dozen provisions



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of §547 were amended by BAPCPA, the changes are significant with respect to the impact they have on how potential preferences should be analyzed by attorneys, financial advisors, debtors and creditors (or potential creditors).

This article will generally outline the amendments to §547 and will specifically focus on the impact of BAPCPA on the "ordinary course of business" defense.

BAPCPA implemented the following amendments to §547:

1. The "ordinary course of business" defense can now be established if the payment is made *either*: (i) in the ordinary course of business or financial affairs of the debtor and the transferee

¹ The views expressed in this article are those of the authors and do not necessarily represent those of Deloitte Financial Advisory Services LLP or Winstead Sechrest & Minick PC.

² References herein to the "Bankruptcy Code" refer to title 11 of the U.S. Code.

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or (ii) according to ordinary business terms. (BAPCPA changed the "and" to "or" in §547(c)(2), thereby protecting transfers that meet either of these "ordinary" requirements from avoidance);

2. Section 547(c)(3)(B) was amended to increase the time given to creditors

to perfect purchase-money security interests from 20 to 30 days after the debtor receives the goods;

3. In non-consumer cases, transfers with an aggregate value of less than \$5,000 are not avoidable;

4. Sections 547(e)(2)(A), (B) and (C) were amended to

increase the time given to secured creditors to perfect liens from 10 days to 30 days to avoid preference exposure;

5. Section 547(h) was added to provide that the trustee (or debtor-in-possession (DIP)) cannot avoid a transfer made as part of an alternative payment schedule created by an approved nonprofit budget and credit counseling agency; and

6. Section 547(i) was added to provide

that if the trustee (or DIP) avoids a transfer by the debtor to an entity that is not an insider for the benefit of an insider, such transfer shall be considered to be avoided only with respect to the creditor that is an insider and not as to the initial non-insider transferee.³

Other BAPCPA Amendments Related to Preferences

BAPCPA amendments to other statutes can also impact preference litigation under §547. For instance, the BAPCPA amendments to the venue provisions of 28 U.S.C. §1409(b) now require the trustee (or DIP) to bring preference actions, seeking to

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avoid transfers of non-consumer debts to noninsiders of \$10,000 or less in the district court where the defendant resides.

Prior to BAPCPA, trustees could sue to recover transfers exceeding \$1,000 in the district where the bankruptcy case was pending, making it costly and inconvenient for creditors residing outside the district where the bankruptcy case was pending to defend preference actions. This often resulted in creditors feeling compelled to pay "nuisance value" settlements in smaller preference actions, regardless of the merits of any existing defense, because the cost



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³ The addition of §547(i) was implemented to fully resolve the statutory construction that supported the Seventh Circuit's holding in *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio)*, 874 F.2d 1186 (7th Cir. 1989). In *Levit*, the court, interpreting §550 of the Code (the avoidance recovery provision of the Code) in conjunction with §547, held that the trustee could recover a preferential transfer from a non-insider transferee where the transfer was only avoidable as to the insider that benefited from the transfer. Subsequent amendments to §550 eliminated the ability to recover a preferential transfer from a non-insider initial transferee in these circumstances; however, this only applied to the recovery of a preference and did not eliminate the statutory ability of the trustee to avoid the transfer to the non-insider under §547. In other words, a transfer, such as the creation of a lien, could still be avoided under §547 as to the non-insider. Section 547(i) now makes it clear that under these circumstances, the transfer to the non-insider transferee can neither be avoided nor recovered as to the non-insider initial transferee.

of defending the action in another district outweighed the potential judgment amount. Now, trustees might be more reluctant to bring preference actions to avoid transfers of \$10,000 or less against creditors residing in districts outside of where the bankruptcy case is pending because the cost of pursuing smaller preference actions in another district could outweigh the potential recovery for the bankruptcy estate.⁴

The New “Ordinary Course of Business” Defense

The BAPCPA amendment that may have the most significant impact on preference litigation is the change in the “ordinary course of business” defense provision that now allows a preference defense if the transfer is made either: (1) in the ordinary course of business or financial affairs between the debtor and the specific transferee (“subjective” ordinary course of business standard) *or* (2) according to ordinary business terms (“objective” ordinary business terms standard).⁵ Prior to the enactment of BAPCPA, in order to establish the ordinary-course-of-business defense, preference defendants had to prove that the alleged preferences were made according to both the subjective ordinary-course-of-business *and* the objective ordinary-business-terms standards.

For example, assume Debtor A routinely paid its creditors between 41 and 50 days after receipt of an invoice, which was the ordinary course of business between Debtor A and its creditors, while the common or ordinary business terms for payment from companies like Debtor A to creditors in this industry ranged from 30 to 60 days after receipt of the invoice. Using these facts, assume that during the 90 days prior to the bankruptcy filing date (the “petition date”), Debtor A made the following payments to one of its vendors, Vendor A:

Days after Receipt of Invoice	Payments
30 to 40 days	\$15,000
41 to 50 days	\$5,000
51 to 60 days	\$10,000

⁴ There is some debate over the applicability of 28 U.S.C. §1409(b) to preference actions because the venue statute applies to proceedings “arising in or related to” a bankruptcy case, and preference actions are proceedings “arising under” the Code. Although this issue was raised prior to the enactment of BAPCPA, the statute failed to include language to incorporate actions “arising under” the Code. See “Preference Venue’ Amendment’s Plain Meaning Excludes Preferences,” *Bankruptcy Court Decisions Weekly News & Comment*, Vol. 46 Issue 21 at p.p. 1, 4 (Aug. 15, 2006).

⁵ The terms “subjective” and “objective” are commonly used to describe the two prongs of the ordinary-course-of-business defense. The first prong is said to be “subjective” because it involves analysis of the transfers in question relative to the prior course of dealing that existed between the particular debtor and creditor involved. In contrast, the “objective” standard involves comparison of the transfers involved against the “objective” standards of the relevant industry (or, now, perhaps to general business standards).

Under the pre-BAPCPA preference-defense provision, Vendor A could only establish that \$5,000 in payments were protected by the ordinary-course-of-business defense because only \$5,000 in payments were made according to both the subjective ordinary course of business *and* the objective ordinary-business-terms standards.

On the other hand, it appears that under the BAPCPA-amended ordinary-course defense, Vendor A could establish that all \$30,000 in payments are protected by the ordinary-course-of-business defense because all of the payments were made either according to the subjective ordinary-course-of-business standard or the objective ordinary-business-terms standard.⁶

From this example, it is clear that the amended ordinary-course-of-business defense provision gives greater flexibility in defending creditors in terms of receiving payments that are less likely to be avoided in the future. For bankruptcy planning purposes, key creditors can be paid according to the more beneficial terms afforded by either the subjective ordinary-course-of-business standard or the objective ordinary-business-terms standard. Creditors might find comfort, and perhaps continue doing business with a debtor in a distressed financial position, knowing that they have a broader and more flexible preference defense shield under the amended ordinary course of business defense.⁷ But how much flexibility does the new provision actually provide?

The flexibility available to potential preference defendants under the new ordinary-course-of-business defense will likely be a function of several factors, including courts’ conclusions on the following issues:

1. Can a creditor arbitrarily base a preference defense on either (or both) the subjective ordinary-course-of-business provision or the objective ordinary-business-terms provision under any and all circumstances?
2. What is the meaning of the objective “ordinary business terms” standard under the amended §547(c)(2)(B)?

In analyzing the new ordinary-course preference defenses under BAPCPA, a preliminary issue that should be addressed is whether a creditor can arbitrarily rely on either, or both, the subjective ordinary-course-of-business provision or the

objective ordinary-business-terms provision regardless of the prior course of conduct or payment history involved. Additionally, it will be interesting to see whether one provision or the other will be more persuasive or relevant in establishing a preference defense based on the particular facts and circumstances of the case and the prior history of dealings between the debtor and the creditor.

Early Case Gives Insight to the “New” Defense

In a recent case, *In re National Gas Distributors LLC*,⁸ the U.S. Bankruptcy Court for the Eastern District of North Carolina addresses some of the questions created by the BAPCPA amendments to the ordinary-course-of-business defense (or, now, defenses). In *National Gas Distributors*, the court concluded that the “new” objective ordinary-business-terms standard under BAPCPA stands on equal footing with the “new” separate subjective ordinary-course-of-business defense, and the objective standard may be invoked by a creditor even in instances where a course of dealing existed between the parties, and “the transfers at issue clearly deviate from that course of conduct.”⁹

Accordingly, at least one court has now concluded that the two separate prongs of the ordinary-course-of-business defense may be asserted, regardless of the prior course of dealing between the creditor and the debtor. The court’s conclusion supports the argument that the amended ordinary-course-of-business provisions allow for either defense to be used in spite of the seemingly divergent results that may arise.

The meaning of the objective “ordinary business terms” standard is another issue that undoubtedly will be subject to much debate and interpretation. Prior to BAPCPA, courts often analyzed the objective ordinary-business-terms element in conjunction with, and often as subordinate to, or as a subsidiary element of, the subjective ordinary-course-of-business provision.¹⁰ This led to some courts evaluating the relative importance of the objective standard based on the pre-petition relationship and course of dealing between the debtor and the creditor.¹¹ Courts also struggled with the issue of what relevant “industry standard” is applied when determining whether a certain transfer

⁸ 346 B.R. 394 (Bankr. E.D.N.C. 2006).

⁹ *Id.* at 402.

¹⁰ See *Advo-System Inc. v. Maxway Corp.*, 37 F.3d 1044, 1049-50 (4th Cir. 1994).

¹¹ See *Fiber Lite Corp. v. Molded Acoustical Prods. Inc. (In re Molded Acoustical Prods. Inc.)*, 18 F.3d 217 (3d Cir. 1994).

satisfied the objective ordinary-business-terms standard. Some courts focused on the debtor's industry when analyzing whether the objective ordinary business terms were met for a particular transfer.¹² Other courts applied the standards in the creditor's industry to determine whether a transfer satisfied the objective element.¹³

In *National Gas Distributors*, the court analyzed pre-BAPCPA case law related to the objective ordinary-business-terms standard and applied a different interpretation. The court concluded that the objective "ordinary business terms" standard meant that in addition to evaluating the specific industry standards of the debtor and its creditors, the court must also consider ordinary business terms common to *all* business transactions in *all* industries.¹⁴ The court ruled that transfers were not to be judged solely based on specific trade terms used by the debtor or its creditors, but consideration must be afforded to ordinary business standards applicable to business in general.¹⁵ The court stated:

Now that "ordinary business terms" is a separate defense, the court must consider the industry standards of both the debtor and its creditors. Furthermore, there are general business standards that are common to all business transactions in all industries that must be met.¹⁶

Thus, it appears that the pre-BAPCPA interpretations of the objective ordinary-business-terms provision may not apply to post-BAPCPA preference defenses now that courts are required to evaluate the objective standard as a stand-alone defense. The pre-BAPCPA case law suggests that courts were influenced by the subjective ordinary-course-of-business provision when evaluating the then-related objective element. Now it appears that courts may analyze general business practices and standards, in addition to relevant industry standards, when evaluating the objective ordinary business terms defense.

Although creditors may find some comfort in knowing that now two independent ordinary-course defenses can be asserted under all circumstances, it should be noted that in *National Gas Distributors*, the court ultimately held that the payments in question were avoidable because they were not made

according to "ordinary business terms." In interpreting the new meaning of the objective ordinary-business-terms standard, the court concluded that the payments were consistent with industry practice from the creditor's perspective, but that the debtor's actions were not made according to ordinary business terms or "sound business practice in general."¹⁷ ■

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¹² See *In re Accessair Inc.*, 314 B.R. 386, 394 (8th Cir. BAP 2004).

¹³ *In re Advo-System*, 37 F.3d at 1048.

¹⁴ *National Gas Distributors*, 346 B.R. at 404-5.

¹⁵ *Id.* at 405.

¹⁶ *Id.*

¹⁷ *Id.*