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## ATTORNEY COMMUNICATION - NEWSLETTER

### Two Key Defenses to Bankruptcy Preference Avoidance Suits

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The U.S. economy has been inundated with corporate bankruptcy filings. Bankruptcy filings have increased by 40%.<sup>1</sup> In many of those bankruptcy actions the trustees file hundreds of preference avoidance actions seeking to avoid or recover transfers (i.e. payments) made by the debtor to creditors within 90 days<sup>2</sup> of the bankruptcy filing. Such an action is generally called a "Preference Avoidance Suit."

The general theory behind a Preference Avoidance Suit is twofold: (1) to promote equal distribution of the bankrupt estate to all creditors by preventing a company which knows it is going into bankruptcy from preferring some creditors over others; (*Begier v. United States I.R.S.*, 496 U.S. 53 (1990)); and (2) to deter aggressive collection methods by not allowing a creditor to keep the fruits of their efforts thereby increasing the chances a business will survive (*Matter of Vance* (9<sup>th</sup> Cir. 1983)).

Regardless of whether there was an effort to prefer any particular creditor, the bankruptcy estate will typically retain a contingency law firm to file a Preference Avoidance Suit against all creditors who were paid during the 90 days leading up to the bankruptcy ("preference period") to recover the money they were paid. The contingency law firm will be paid based on a percentage of what it recovers. Unfortunately, it is not a defense that the debt paid was legitimately owed or even that the debtor still owes the creditor a large balance. Nonetheless, companies who are sued in a Preference Avoidance Suit do have several effective defenses including the two discussed below.

#### 1. Subsequent Advance of New Value Defense

The "subsequent advance of new value" defense allows a creditor that has given the debtor new goods or services during the 90 day preference period *after* receiving an alleged preferential transfer, to offset the value of those goods or services against the amount of the alleged preferential transfer. This is done to give a creditor an incentive to advance an ailing customer new services or products to help it stay afloat in the hopes of avoiding bankruptcy altogether. *Southern Technical College, Inc. v. Hood*, (8<sup>th</sup> Cir. 1996).

The elements of the "subsequent advance" defense are: (1) the creditor must have given "new value" to or for the benefit of the debtor after the preferential transfer was made; (2) the "new value" must have been given on an unsecured basis; and (3) the creditor must have received

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<sup>1</sup> Reuters, "U.S. business bankruptcy filings rise to the highest since 2005." Thursday April 1, 2010

<sup>2</sup> The 90 day period is increased to one year if the creditor was an "insider" like the debtor's relative, individual general partner, director or officer.

no payment for the new value from the debtor or, if paid, the payment must also be avoidable. 11 U.S.C.A. §547(c)(4)(A) and (B); see also *In re IRFM, Inc.* (9<sup>th</sup> Cir. 1995).

To establish the amount and applicability of this defense, it is not sufficient for the creditor to simply add up the value of the goods or services provided on a non-secured basis during the 90-day period and deduct that amount from the amount of money paid to the creditor during the 90-day period. Instead, the defense only applies to value provided after a given payment at issue. *In re IRFM, Inc., supra*. Thus, after each payment, the creditor must find applicable value provided at a latter point in time and any new value provided prior to the payment does not apply. *Id.*

## 2. Ordinary Course of Business Defense

The “ordinary course of business” defense sounds fairly simple and straight forward but the manner in which it is applied by courts and trustees can be complicated and sometimes counter-intuitive. The elements of the defense are that the transfer/payment was: (1) in the payment of a debt incurred by the debtor in the “ordinary course of business”; **and** (2) made either in the ordinary course of business of the debtor and creditor **or** according to ordinary business terms defined by the parties’ industry standards. 11 U.S.C. §547(c)(2).<sup>3</sup>

The underlying policy of this defense is to prevent “‘dismember[ment] of the debtor during his slide into bankruptcy,’ by enabling the debtor to make unavoidable payments that enable ‘the struggling debtor to continue operating its business.’” *In re Northpoint Communications Group, Inc.*, (N.D. Cal. 2007).

Satisfying the first prong of the “ordinary course of business” defense is usually fairly easy for an established business providing goods or services. For example, this may be done with evidence that the creditor is in the business of providing the types of goods or services that were provided to the debtor to parties similar to the debtor and that those goods or services were actually provided to the debtor. Courts are also interested in “whether or not the debt was incurred in a typical, arms-length commercial transaction that occurred in the marketplace, or whether it was incurred as an insider arrangement with a closely-held entity.” *In re Central Valley Processing, Inc.*, (E.D. Cal. 2007).

The second prong is usually more challenging. Here, the creditor must prove that all of the payments were made: a) in the ordinary course of business between the parties or b) made according to the ordinary business terms typically adhered to in the relevant industry.

### A. Ordinary Course of Business Between the Parties

Factors bearing weight on whether the payments at issue were made within the ordinary course of business between the parties may include the length of the parties’ relationship, the amount and form of the transfer in comparison to the parties’ past practices, whether the creditor employed any unusual collection strategy and whether the creditor knew or took advantage of the debtors’ precarious financial condition. *In re Grand Chevrolet* (9<sup>th</sup> Cir. 1994).

Analyzing these factors requires an in-depth analysis of the parties’ prior course of dealing, the

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<sup>3</sup> For cases commenced before October 17<sup>th</sup> 2005, 11 U.S.C. §547(c)(2) required a creditor to prove that a transfer and payment was made both in the ordinary course of business between the parties *and* according to ordinary business terms within the industry.

promptness, frequency and size of the historical payments. Generally, the number of days that the bankrupt debtor took to pay the creditor's invoices *prior* to the 90-day preference period is compared to the timeliness of the payments made *during* the 90-day preference period.<sup>4</sup>

The actual terms of the parties' agreement may also provide evidence whether the payments were in the ordinary course of business but even if payments are late it would not be conclusive. In *In re Yurika Foods Corp.* (6<sup>th</sup> Cir. 1989), the court concluded that late payments became the ordinary course of dealing between the parties where 87% of the payments made during the pre-preference period were made after the period specified in the bills. *See also In re Valley Steel Corp.*, (W.D. Virginia 1995) (court rejected *per se* rule because "such a bright line rule ignores the realities of commercial practice in the industry involved in [the] case.")

Indeed, courts have consistently held that whether payments were made within the ordinary course of business is subjective. There is no precise legal test (no bright line rule) that is applied to determine whether payments during the 90-day period are made in the ordinary course of business; rather, the courts engage in a "peculiarly factual analysis". *Lovett, supra*. One judge attempted to sum up the bankruptcy courts' seemingly highly subjective and "peculiarly factual" approach to this second prong, basically stating "I know it when I see it." *In re Central Valley Processing, Inc.*, (E.D. Cal. 2007). Here are some examples of how courts analyzed the defense:

- *In re Cyberbate.com* (E.D.N.Y.2003): A jewelry supplier had transacted business with debtor for 7 months on net 30 days terms. The debtor had paid the jewelry supplier on average within 28 days from invoice. Two payments made during the 90 day preference period were at issue. The first payment applied to an invoice 90 days old and to a second invoice 97 days old. The second payment applied to an invoice 31 days old. The court held that the payment for the 90 and 97 day old invoices was not made within the ordinary course of business, but that the payment of the 31 day old invoice was made in the ordinary course of business.
- *In the Matter of Writing Sales Ltd. Partnership* (E.D. Wis.1989): The court held that payments made 72 days after the invoice date were not in the ordinary course of business because payments had historically been made on average at 58 days.
- *In re Valley Steel Corporation* (W.D. Va.1995): This case involved a steel fabricator purchasing rebar from creditor NJS. The court held that individual payments to NJS made 119 days after the invoice date deviated too substantially from the pre-preference average of 54 days to be in the ordinary course of business. The court also rejected a payment made only 26 days after invoice as being quicker than the pre-preference average. Finally, the court found that a payment made by wire transfer was not in the ordinary course of business because all other payments were made by ordinary company check.
- *In re CIS Corp.*(S.D.N.Y.1997): The court held that since the 80-day collection period during the preference period was "almost a month later" than the pre-preference

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<sup>4</sup> How much history should be analyzed? Typically, only up to four to five years of the business relationship will be analyzed since anything beyond that may be considered "too remote." *In re Central Valley Processing, Inc.*, 360 B.R. 676, 677 (2007).

average collection period of 51 days, the creditor failed to meet its burden of proving the ordinary course of business defense.

- *In re Bank of New England Corp.* (D. Mass.1993): Pre-preference period payments consisted of 15 payments made on average 38.4 days from invoice date. The average outstanding during the preference period was 54.7 days. The court held that payments made between 42 and 59 days during the preference period fell within the ordinary course of business defense, but that one payment made 124 days after the invoice date was preferential.
- *Samar Fashions, Inc.* (E.D. Pa.1990): The court found that 88-day payment delays and beyond were “abnormally long delays,” where the average collection period during the parties’ business relationship was 45 days after the date of invoice.
- *In re National Enterprises, Inc.* (E.D.N.Y.1995): Thirty-six (36) payments made during the pre-preference period were made on average 6.86 days late. Nine of those payments immediately preceding the preference period were made on average 12 days late. The court held that the fact that the last pre-preference period payment was 28 days late was insufficient to show a “routine” and thus found that payments made 22 days late and beyond failed to meet the ordinary course of business defense.

An arguably reliable method for comparing pre-preference payments and preferential period payments is to calculate the standard deviation in the payments. The standard deviation is the measure of statistical dispersion. It describes how spread out a set of values is around the mean of that set of values. In the ordinary course of business analysis, standard deviation measures how much variation in the number of collection days is to be expected (the typical variation) from the average number of collection days. Arguably, the fact that an invoice paid during the preference period within the range of one standard deviation either above or below the average collection days during the pre-preference period would be evidence that it was made in the ordinary course of business.

While such a specific analysis was not performed by the court in *In re Central Valley Processing*, the court touched upon the basic methodology, stating “an analysis of individual payments shows there are four payments that do not appear ordinary because they deviate substantially from the average both before and during the preference period.” *In re Central Valley Processing, supra*. See also *In re The Consolidated FGH Liquidating Trust*, (S.D. Miss. 2008) (bankruptcy trustee’s expert witness testimony offered a standard deviation analysis of parties’ prior payment practice sufficient to defeat creditor’s ordinary course of business defense).

#### *B. Ordinary Business Terms*

Finally, even if the preferential transfers do not fall within the ordinary course of business between the parties, they may have been made according to the ordinary business terms in the industry. This analysis would take similar form to the ordinary course of business between the parties, but taking an industry-wide perspective at whether the payment practices at issue comport with the standard of the industry. *In re Grand Chevrolet, Inc.* (9th Cir.1994).

This inquiry is more objective, comparing the credit arrangements between other similarly situated debtors and creditors in the industry to see whether the payment practices at issue are

“consistent” with the industry practice. *In re Loretto Winery* (9<sup>th</sup> Cir.), *In re Gulf City Seafoods, Inc.* (5<sup>th</sup> Cir. 2002). Consistent does not necessarily mean identical. The courts recognize that *strict* conformity is not realistic, and the law "should not push businessmen to agree upon a single set of billing practices." *In re Gulf City Seafoods, Inc., supra*. Rather, "ordinary business terms" refers to 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 C." *In re Tolona Pizza Products Corp.* (7<sup>th</sup> Cir. 1993). To prove this defense, the creditor may offer expert testimony as to the time it usually takes in the industry for payments to be received on invoices with terms similar to those used between the parties. *In re Central Valley Processing, supra*.

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