

BUYING TROUBLE

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Keeping Payments "Ordinary" to Avoid Preference Exposure

Creditors are often surprised to learn that they may be required to turn money over to a debtor's bankruptcy estate. There are steps a creditor can take, however, to try to keep payments from a debtor to the creditor "ordinary" in order to avoid this result. Under the Bankruptcy Code, the debtor in bankruptcy or the trustee of a bankrupt debtor can seek the return of payments made to creditors that were made during the 90 days preceding the filing of the debtor's bankruptcy case (known as the "Preference Period") if the transfers are "preferential." 11 U.S.C. § 547(b)(4). A payment made during the Preference Period may be "preferential" if it "enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate." Barrett Dodge Chrysler Plymouth, Inc. v. Cranshaw (In re Issac Leaseco, Inc.), 389 F.3d 1205, 1209 (11th Cir. 2004) (quoting Union Bank v. Wolas, 502 U.S. 151, 160-61, 112 S.Ct. 527, 533 (1991)).

The Bankruptcy Code provides various defenses that a creditor may assert to the recovery of preferential transfers. 11 U.S.C. § 547(c). One such exception is the ordinary course of business exception of 11 U.S.C. 547(c)(2). For this exception to apply, the transfer must be in payment of a debt that was incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor and the payments be: (1) made in the ordinary course of business or financial affairs of the debtor and the creditor (subjectively ordinary), or (2) made according to ordinary business terms in the applicable industry (objectively ordinary). 11 U.S.C. § 547(c)(2). The "subjective prong" of this defense requires proof that the debt and its payment are ordinary as compared to other business dealings between the creditor and the debtor. Logan v. Basic Distribution Corp. (In re Fred Hawes Organization, Inc.), 957 F.2d 239, 244 (6th Cir. 1992). Below are several points that a trade creditor should keep in mind in its dealings with its debtors to help the creditor avoid large preference exposure and/or preserve the subjective prong of the ordinary course defense.

1. Be Wary of Any Change in the Timing of Payments.

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A key factor courts consider when determining whether a payment was made in the “ordinary course” as compared to previous payments made by the debtor to the creditor is the timing of the payment. If a preferential payment was made much more quickly or much more slowly, as compared to the timing of payments made historically by the debtor to the creditor, the ordinary course defense may not be accepted by the court. To help protect the ordinary course defense, a creditor should be aware of the amount of time it typically takes a debtor to pay. If payments come to the creditor that deviate from the typical practice, either because they are made much more quickly or much more slowly, the creditor should determine the reason why the payments do not comport with the debtor’s prior practice. If the change in payment practice relates to financial difficulties being experienced by the debtor, as opposed to some other issue that regularly arises in the creditor’s dealings with the debtor, a court might ultimately reject an attempt by the creditor to rely on the ordinary course defense.

2. Be Wary of Different Methods of Payments.

Another factor courts consider in determining whether a preferential payment was made in the ordinary course as compared to previous payments made by the debtor to the creditor is whether the preferential payment was made by the same method by which previous payments were made. For instance, if a debtor typically made payments to the creditor by wire transfer but the preference payments were made by check, the ordinary course defense may be rejected by the court. Creditors should take note of any change in the debtor’s method of payment and determine the reason or reasons why the change was made. If the change in method of payment did not relate to the deteriorating financial condition of the debtor, the ordinary course defense may still apply.

3. Be Wary of Changes in Whether Payments are Made in Whole or in Part.

An additional factor courts may take into account in determining whether a preferential payment was made in the ordinary course as compared to previous payments made by the debtor to the creditor is whether there was any change with respect to whether the payments made by the debtor to the creditor were payments in full or partial payments. For example, if a debtor typically pays invoices in full, but, during the 90 days before the bankruptcy filing, began making only partial payments on invoices, the subjective ordinary course defense might be rejected. To help protect the ordinary course defense, a creditor should be aware of how the debtor typically handles outstanding invoices. For instance, the creditor should note whether a debtor typically makes payments on invoices in full or in part and whether the debtor typically makes payments that cover invoices individually or whether it pays invoices in batches. If payments come to the creditor that deviate from the typical practice, the creditor should determine the reason why the payments do not comport with the debtor’s prior practice. If the change in payment practice relates to financial difficulties, a court might ultimately reject an attempt by the creditor to rely on the ordinary course defense.

4. Be Wary of Requests to Change Payment Terms.

In considering whether the ordinary course of business defense will prevent the debtor or the bankruptcy trustee from recovering payments made by a debtor to a creditor in the 90 days before the debtor’s bankruptcy, courts might also consider whether there has been a change in the written payment terms between the debtor and the creditor. As such, a creditor should be wary of any request by the debtor to change the payment terms between the parties. A request for a change in terms might be a red flag to the creditor (or, eventually, to a court) that the debtor is experiencing financial difficulties. If a debtor makes such a request, the creditor should be sure to be clear about why the debtor is making the request. If the debtor is financially healthy, a change in the terms may not be problematic. For instance, if a debtor requests a change from payment in net 30 days to payment in net 45 days, and the reason for the request for the change does not relate to any deteriorating financial condition of the debtor, assuming the parties abide by the new terms, there might be enough time between the change in terms and any future bankruptcy filing by the debtor to allow the new terms to become the ordinary course between the parties.

5. Be Mindful of Collection Efforts.

In determining whether payments made in the 90 days before the debtor's bankruptcy filing should be protected from recovery as made in the ordinary course of dealings between the parties, courts also consider whether the payments were made in response to "unusual" debt collection activities by the creditor. In order to make this determination, courts will normally compare the pattern of collection activities occurring historically between the parties against the collection activities that preceded the preference payments to see if the activities preceding the preference payments fit the historical pattern. Creditors should take heed of collection efforts with their debtors. Collection activities that precede preference payments and are more intense as compared to collection activities by the creditor historically may take the payments outside of the ordinary course between the parties. A creditor that finds itself increasing its collection activities with a particular debtor should investigate the situation with the debtor to determine whether the need for increased collection activity relates to a deteriorating financial condition.

Conclusion

If a creditor learns that any of the changes in the typical practices established between the parties that are discussed above do relate to the debtor's deteriorating financial condition, as opposed to some other issue that regularly arises in the creditor's dealings with the debtor, and the creditor is unable to persuade the debtor to conform to its prior pattern of dealing, the creditor should assess the situation and determine whether to continue doing business with the debtor. A creditor may determine that the benefit of continuing to do business with the debtor is worth the risk of potential preference exposure in the event the debtor files bankruptcy. Conversely, the creditor may conclude that the benefits do not outweigh the risk and decide to end their dealings with the debtor.

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