Revised Ordinary Course of Business Defense to Preference Claims May Not Be as Effective as Anticipated

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Preference claims have long been the bane of vendors and other creditors that have worked with and continued to extend credit to slow paying customers, or long term customers that suddenly found themselves struggling to pay their obligations as they became due. These creditors, who generally acted in good faith and attempted to work with customers through these difficult times, were often "rewarded" with lawsuits by bankruptcy trustees, debtors-in-possession or creditors committees seeking to recover payments made by customers that ultimately filed for bankruptcy protection. Defending against these "preference actions" is costly and time consuming, requiring unsuspecting vendors to defend difficult, technical litigation in unfamiliar and faraway jurisdictions.

Substantial revisions to the Bankruptcy Code became effective in October 2005. One such revision was intended to make it easier for creditors to defend against preference actions. Pursuant to § 547 of the Bankruptcy Code, a trustee in bankruptcy may recover payments made by the debtor to the creditor in the 90 days immediately preceding the bankruptcy filing date. Under the prior law, the "ordinary course of business defense" to a preference action required the creditor to establish that the payment was made: (i) in the ordinary course of business or financial affairs of the debtor and the creditor (the "subjective test"); and (ii) according to ordinary business terms (the "objective test"). This two-pronged test was difficult and expensive to establish, often requiring the creditor to prove important elements of the defense utilizing expert testimony at trial.

Under the revised Bankruptcy Code, it was thought that the creditors' burden has been significantly reduced. The revised statute provides that creditors may defend a preference action by establishing that a transfer was made: (i) in the ordinary course of business or financial affairs of the debtor and the creditor; or (ii) according to ordinary business terms. Under the new law, establishing either prong of the test will relieve the creditor from liability in a preference action.

However, in In re National Gas Distributors, LLC, 2006 WL 2135557 (Bankr. E.D.N.C.), the bankruptcy court for the Eastern District of North Carolina ruled that while the creditor only need establish one prong of the defense under the revised statute, it required the court to consider both the ordinary business terms of both the debtor's industry, and the creditor's industry. Holding that payments made by the debtor to the creditor were not according to ordinary business terms of both the debtor and the creditors, it granted the trustee's claim to avoid the transfers as improper preferential transfers.

In In re National Gas, the debtor made two payments totaling in excess of $3 million to its lender. The obligations were guaranteed by the individual principal of the debtor and his spouse, and secured in party by some or all of the spouse's assets. Each of the obligations had matured prior to the date that the payments were made; however, the maturity dates had been extended several times pursuant to written agreements prior to the actual payment of the obligations.

The trustee commenced an action to avoid and recover the payments as improper preferential transfers in violation of 11 U.S.C. § 547. Pursuant to the revised Bankruptcy Code, the lender argued that the payments were made according to ordinary business terms. In support of its position, the bank submitted the affidavit of one of its loan officers, who had more than 30 years experience in the banking industry. The affidavit alleged that: (i) the terms of the extensions of credit were customary for this particular lender and the banking industry in general; (ii) it was customary practice of this lender and in the banking industry to extend maturity dates on loans, and the extensions were granted on standard and ordinary terms using the lender's standard forms; (iii) it is standard in the industry for borrowers to pay loans immediately prior to the maturity date; and (iv) all of the payments were made pursuant to the terms and conditions of the credit agreements as modified by the extensions.

The bankruptcy court rejected the lender's arguments, holding that the payments made constituted voidable preferential transfers and could be recovered by the trustee. The court noted that the bank's affidavit and submissions with respect to the custom and practices of the lender and the banking industry were too general to establish industry norms. Further, the court held that the ordinary business terms defense required it to consider not only the lender's industry standards, but also the debtor's industry standards and the standards applicable to businesses in general. In analyzing those standards, the court held that the conduct of the debtor in paying its loans was "not in accordance with ordinary business terms." It recognized that the debtor was going out-of-business, and paying off obligations which were guaranteed by the principal and his spouse and secured by the spouses' assets, stating "these payments were not made according to ordinary business terms and are not the types of transfers that the ordinary business terms defense is designed to protect."

The revisions to § 547 of the Bankruptcy Code were intended to reduce the burden on creditors in defending against preference actions. However, Natural Gas illustrates that while creditors are no longer required to establish both prongs of the ordinary course of business defense, those creditors are now on notice that courts may interpret both the industry standards of the creditor and the debtor in analyzing whether or not payments are made according to ordinary business terms. The issue is far from settled, and will require appellate review to resolve differences in approach. While it is too early to determine whether other bankruptcy courts will follow this decision, it may be that the new provision does not provide the level of relief intended by the drafters of the revised Bankruptcy Code.

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