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AVOIDANCE ACTION REPORT

A Bi-Annual Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

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Material Factual Disputes as to Appropriate Historical Range and Ordinary Course Methodologies Preclude Summary Judgment on Both Ordinary Course and New Value Defenses

Stanziale v. Superior Technical Resources, Inc. (Powerwave Technologies, Inc.), 2017 WL 1373252 (Bankr. D. Del. April 13, 2017)

In *Stanziale v. Superior Technical Resources, Inc.*, the chapter 7 trustee for Powerwave Technologies commenced an action against Superior Technical Resources to recover, among other things, certain alleged preferential transfers pursuant to section 547 of the Bankruptcy Code. Section 547 of the Bankruptcy Code allows a trustee or debtor in possession to avoid a transfer made by a debtor while insolvent to or for the benefit of a creditor on account of an antecedent debt within 90 days (or one year in the case of an "insider") of the petition date, where such transfer enables the creditor to receive more than it would have received in a chapter 7 liquidation. The defendant did not dispute that the trustee made his *prima facie* case but sought summary judgment with respect to its two asserted affirmative defenses, ordinary course of business and subsequent new value under section 547(c)(2) and (4) of the Bankruptcy Code. The court denied the relief sought in the motion in its entirety.

In this case, the debtor filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code on January 28, 2013 and sought to convert its case to chapter 7 shortly thereafter. Upon conversion, the trustee was appointed to administer the chapter 7 proceeding. Prior to the bankruptcy filing, defendant provided the debtor with temporary contract personnel pursuant to an agreement entered into on September 12, 2008 and renewed on an annual basis. During the course of their relationship, defendant sent invoices to the debtor and required payment within 45 days from the invoice date. The debtor typically paid multiple invoices with each payment, which were made via wire transfer. Occasionally, when payments were late, defendant followed up by email on the status of outstanding payments. During the preference period, in November 2012, defendant's employees corresponded concerning the need to reduce the debtor's $200,000 aging balance. On December 7, 2012, defendant notified the debtor that its payment terms were changed from net 45 to net 7. Defendant further informed the debtor that it considered the debtor's account high risk and demanded payment in full by

the close of business on December 12, 2012. The debtor wired a payment to the defendant on December 12 and made weekly payments thereafter until the petition date.

In its summary judgment motion, defendant argued that the preference period transfers were made in the ordinary course of business and could not be avoided. Pursuant to section 547(c)(2)(A) of the Bankruptcy Code, a defendant may assert that transfers are protected from avoidance because they were both incurred and paid for in the ordinary course of business between the defendant and the debtor. The subjective ordinary course of business analysis requires the court to look at the circumstances surrounding the payments during the preference period and compare them to the historical transactions of the parties. As an initial matter, the court noted that the defendant and the trustee relied upon different timeframes to establish the historical baseline course of dealings; with the trustee relying upon a longer pre-preference time period and arguing that it presents a more accurate picture of the historical dealings because it includes time when the debtor was healthy. The court noted the well-established tenet that the historical period should incorporate the time period when the debtor was financially healthy and observed that both the defendant and the trustee included time when the debtor's financial condition was deteriorating but defendant did not include a sustained period when the debtor was financially healthy. As a result, the court concluded that a factual dispute existed as to the appropriate historical period.

In addition, the court found that a material dispute existed as to the appropriateness of the methodologies used by the defendant to conclude that payments were made in the ordinary course of business. Specifically, defendant argued that historically payments were made between 34 and 371 days from invoice date and that all preference period payments were made within that range. The trustee countered that this range was overbroad and included outliers. Indeed, defendant's historical data included a three and a half month period during which no payments for services were made yet defendant made no adjustments for this gap in payments through its methodology. The court concluded that a genuine factual dispute existed as to the appropriateness of using the range methodology. The court reached the same conclusion with respect to defendant's proposal to calculate the average payment time for each batch of invoices paid during the preference period and compare it to the average payment time for batches of invoices paid during the historical period. The court noted this would lead to misleading results as the number of invoices paid via a single transfer varied greatly. The court briefly turned to the methodologies utilized in the trustee's ordinary course analysis which included days sale outstanding (comparing the dollar-weighted average of days from invoice date to payment date) and analysis of the standard deviation as a marker for historical payment patterns. The court ultimately declined to make a determination whether specific transfers were shielded by the ordinary course defense in light of the factual dispute as to the proper historical time period to be applied to the analysis. The court further noted that there is an additional factual dispute whether defendant's collection activities precluded application of the ordinary course of business defense to certain payments.

Defendant also asserted a defense under section 547(c)(2)(B) of the Bankruptcy Code, which protects payments made according to the norms in the applicable industry. Defendant asserted it was classified as an employment agency in the administrative and waste management services industry but the trustee countered that its classification was unclear, and thus the proper industry for section 547(c)(2)(B) purposes was in dispute. The court agreed with the trustee and found that a material dispute existed with respect to defendant's property industry classification.

Finally, the court turned to defendant's subsequent new value defense. Section 547(c)(4) of the Bankruptcy Code provides a defense to a preference action based upon new value provided by the defendant after receiving the avoidable transfers. The court noted that in the Third Circuit new value includes both paid and unpaid invoices provided that any paid invoices are not paid by a transfer that is "otherwise unavoidable." The trustee argued that the new value defense could not be decided until a determination is made whether certain transfers may be protected by the ordinary course of business defense and thus "otherwise unavoidable." The court agreed and denied summary judgment as to the new value defense.

COMMENTARY

This decision reaffirms the importance of establishing an appropriate historical baseline period that encompasses time when a debtor is financially healthy and highlights additional areas of common factual dispute, including appropriate methodologies for analyzing subjective ordinary course and proper industry classification for application of the objective ordinary course defense. As illustrated above, these are intrinsically factual exercises that can preclude resolution of matters on summary judgment when in dispute.

Collection Pressure May Be Analyzed in Context of Industry Practices; Factors Who Hold Title to Merchandize Sold Under Factored Invoices Entitled to New Value Credit

Dots, LLC v. Milberg Factors, Inc. (In re Dots, LLC), 562 B.R. 286 (Bankr. D.N.J. 2017))

In *Dots, LLC v. Milberg Factors*, the chapter 11 debtor commenced actions to recover alleged preferential transfers under section 547 of the Bankruptcy Code from factors Milberg Factors and Finance One. At the direction of the court, the debtor-plaintiff sought partial summary judgment regarding the scope and applicability of ordinary business terms defense under section 547(c)(2)(B) of the Bankruptcy Code and subsequent new value defense under section 547(c)(4) of the Bankruptcy Code.

The relationship central to this action was based upon an arrangement between the debtor, certain of the debtor's vendors and the defendants who factored such vendors' accounts receivable. The defendants were parties to factoring agreements with the vendors whereby the factors agreed to purchase the vendors' accounts and thereby obtained full authority to collect and take any other actions on such accounts as sole account owners. The defendants had no direct agreements with the debtor. Prior to the commencement of the debtor's chapter 11 case, the defendants reduced the credit available to vendors for sales to the debtor. This effectively reduced the amount of new inventory the debtor was able to purchase and, as a result, the debtor began paying invoices prior to their due dates to address its inventory needs. The terms of the invoices were never changed to reflect shorter terms.

The court first analyzed the application of the objective ordinary course of business defense – whether the payments were ordinary in the defendants' industry – and could thus be shielded from avoidance under section 547(c)(2)(B) of the Bankruptcy Code. The court noted that this inquiry focuses on the creditor's industry and that the defendants contend the appropriate industry is clothing industry factoring. Next, the court examined the debtor's contention that any credit holds imposed by the defendants are relevant to determining whether transfers were made according to ordinary business terms and would preclude the application of the defense. The court deemed this approach too narrow and stated that the inquiry should instead focus on whether the credit adjustments were

undertaken with the goal of coercing payment or reducing exposure consistent with industry practices. The court deemed the factual record insufficient to make such a determination and denied summary judgment on this issue.

The court then turned to the application of the subsequent new value defense under section 547(c)(4) of the Bankruptcy Code. "New value" is defined in section 547(a)(2) of the Bankruptcy Code to include "money or money's worth in goods, services, or new credit." The defendants contended that they provided subsequent new value in the form of credit; a point disputed by the debtor who argued that the vendors, rather than the factors, provided credit to the debtor. The court concluded that the defendants indeed provided new value to the debtor but that such new value was provided in the form of goods rather than credit. The court reached its conclusion by analyzing the terms of the factoring agreements which provided that once an order was placed with the vendors, the vendors immediately sold and assigned to the defendants their rights in the accounts receivable and the underlying goods sold. As a result, the defendants held title to the goods sold to the debtor.

The court also examined whether new value in a factoring transaction must be evaluated on a vendor by vendor or cumulative basis. The debtor contended that new value must be analyzed on a vendor by vendor basis while the defendants argued that they provided new value directly to the debtor and, as such, it should be calculated on a cumulative basis. The court reiterated its finding that the defendants supplied new value in the form of goods to the debtor. The court further noted that since the new value was provided in the form of goods owned by the defendants there was no need to analyze new value on an individual vendor basis. In light of the court's conclusions on the application of the subsequent new value defense, the debtor's motion for summary judgment was denied.

COMMENTARY:

Contractual language addressing title to merchandize can become a key element in the application of the subsequent new value defense in avoidance actions involving factors. Practitioners should consider the impact of these provisions in drafting factoring agreements and in prosecuting or defending preference actions against factors.

Administrative Expense Claim Eligible for Setoff Against Preference Liability

In re Quantum Foods, LLC, 554 B.R. 729 (Bankr. D. Del. 2016)

In *In re Quantum Foods, LLC*, the Official Committee of Unsecured Creditors of Quantum Foods commenced litigation against Tyson Fresh Meats and Tyson Foods seeking to recover alleged preferential transfers. The committee also sought to disallow any of the defendants' claims against the debtors' estates pursuant to section 502(d) of the Bankruptcy Code, which provides for disallowance of claims held by an entity that received an avoidable transfer unless such entity has satisfied its liability on the avoidable transfer. The defendants contended, among other things, that they were entitled to set off a previously allowed post-petition administrative expense claim against any potential preference liability. The committee moved for summary judgment on the setoff issue.

Defendants supplied meat products to the debtors during the pendency of their chapter 11 cases. When the debtors failed to pay for the goods, defendants sought allowance and payment of an administrative expense claim and obtained an order allowing their administrative expense claim. Subsequently, defendants included counterclaims and third party claims against the debtors with their answer to the avoidance action complaint. Defendants also sought a declaratory judgment that disallowance of claims under section 502(d) of the Bankruptcy Code applies only to pre-petition claims and

therefore would have no effect on their allowed administrative expense claim.

In addressing the setoff issue the court noted it presented a question of first impression in the jurisdiction. As an initial matter, the court observed that the parties agreed that goods or services provided post-petition could not be used as subsequent new value under section 547(c)(4) of the Bankruptcy Code. However, the committee contended that defendants' setoff claim was a disguised new value defense because it effectively reduced the amount of preferential transfers to be returned to the estate. The court found this argument unpersuasive and noted that setoff does not factor into the calculation of the net recoverable preference; rather it affects only the amount actually paid to the estate. The court further explained that defendants' claim fits the definition of setoff – as a counterclaim the defendant holds against the plaintiff that is extrinsic to plaintiff's claim against the defendant. Next, the court concluded that both the administrative expense claim and the avoidance claim held by the estate were post-petition obligations making setoff permissible as post-petition obligations may only be set off against other post-petition obligations while pre-petition obligations may only be set off against pre-petition obligations.

Finally, the court turned to section 502(d) of the Bankruptcy Code and noted that the committee's argument ignored case law finding that administrative expense claims are not subject to disallowance under section 502(d) of the Bankruptcy Code. The court also noted the practical effect of disallowing administrative expense claims on the basis of preference liability may make creditors more hesitant to extend post-petition credit to chapter 11 debtors. For the foregoing reasons the court denied the committee's summary judgment motion.

COMMENTARY

Practitioners should consider whether allowed administrative expense claims may give rise to a right of setoff against potential preference liabilities. This may be a valuable tool for defendants in matters where administrative solvency is a concern and possible barrier to full payment of administrative expense claims.

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