Feature

By Joseph L. Steinfeld, Jr. and Kara E. Casteel

Preference Period Transfers Must Be Compared When Debtor Was Healthy

Joseph L. Steinfeld, Jr.
ASK LLP
St. Paul, Minn.

Kara E. Casteel
ASK LLP
St. Paul, Minn.

Joseph Steinfeld, Jr. is a managing partner and Kara Casteel is an associate at ASK LLP in St. Paul, Minn.

Editor's Note: *For another viewpoint on this case, see the feature on page 26.*

In *Siegel v. Russellville Steel Co. (In re Circuit City Stores Inc.)*,[1] the U.S. Bankruptcy Court for the Eastern District of Virginia held that the defendant had not met its affirmative burden as to the subjective ordinary-course-of-business defense because it failed to establish that the preference period transfers were ordinary as compared to payments occurring when the debtors were financially healthy. The court determined that the appropriate historical lookback period for this defense should not be based on blind adherence to a prescribed one-year period prior to the preference period, but instead must be based on the particular facts and circumstances of the case.

In *Russellville*, this meant that the appropriate historical baseline consisted of transactions occurring prior to the debtors' pre-petition "liquidity event" and did not include historical transactions occurring after the liquidity event. Hon. **Kevin R. Huennekens**'s decision properly acknowledges that the prime objective when comparing preference-period transfers to historical transactions under the subjective ordinary-course-of-business defense is to compare the transfers to a period of time when the debtor was healthy and the parties' transactions were thus *ordinary*. This decision follows case law in the Fourth Circuit and other circuits, and is harmonious with the policies underlying the Code.

Russellvile Steel Co. focused its defense on the subjective rather than objective ordinary course of business. Section 547(c) of the Bankruptcy Code, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[2] permits a "safe harbor" for a transferee of a preferential payment that can satisfy the requirements set forth in either § 547(c)(2)(A) or § 547(c)(2)(B).[3] This section, as amended, provides for two "separate, independent" defenses.[4] In order to establish the subjective criteria of § 547(c)(2)(A), a creditor must generally produce some evidence of the "baseline of dealings" between the parties to "enable the court to compare the payment practices during the preference period with the prior course of dealings."[5] Conversely, under the objective prong, a defendant must prove by a preponderance of the evidence that each payment was ordinary in relation to prevailing industry standards.[6]

The debtors, formerly specialty retailers of consumer electronics, filed petitions for relief on Nov. 10, 2008.[7] Prior to bankruptcy, the defendant had provided steel products under payment terms of Net 30. The entire course of business between the defendant and debtors consisted of 86 invoice payments from August 2006 through the petition date.[8]

In November 2007, the debtors experienced a significant change in liquidity that resulted in the debtors making delayed payments to creditors.[9] Prior to this "liquidity event,"[10] and when excluding outliers, the debtors had paid all invoices to the defendant between 31-41 days after invoice date. After the liquidity event, excluding outliers, the payments increased to 44-51 days from invoice date. During the preference period, the debtors paid three invoices aged at 51, 45 and 46 days, respectively.[11] A fourth transfer, paying an invoice at 189 days after invoice date, was conceded by the defendant as not ordinary.[12]

The parties' sole legal dispute centered on the appropriate historical period upon which to compare the remaining preference period transfers. While the trustee asserted that the pre-liquidity event period was the appropriate period for a comparison of the preference period activity, the defendant asserted that the 12-month period immediately preceding the preference period was appropriate.[13]

The court agreed with the trustee and emphasized that the subjective ordinary-course-defense in the Fourth Circuit is "particularly factual" and requires an analysis of the specific business relationship.[14] The court's

1 10-03317-KRH, 2012 WL 1981781 (Bankr. E.D. Va. June 1, 2012).
2 PL 109-8, April 20, 2005, 119 Stat 23.
3 (c) The trustee may not avoid under this section a transfer—
(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms.
11 U.S.C. § 547(c)(2).
4 *Hutson v. Branch Banking & Trust Co. (In re Nat'l Gas Distrib. LLC)*, 346 B.R. 394, 396 (Bankr. E.D.N.C. 2006) (stating that post-BAPCPA version of § 547(c)(2) includes "ordinary-course-of-business" defense under subsection (A), as well as "ordinary business terms" defense under subsection (B)).
5 *Schick v. Herskowitz (In re Schick)*, 234 B.R. 337, 348 (Bankr. S.D.N.Y. 1999).
6 *In re Food Catering & Housing Inc.*, 971 F.2d 396, 398 (9th Cir. 1992) (citing *In re Fred Hawes Organ Inc.*, 957 F2d 239, 244 (6th Cir. 1992)).
7 *Siegel v. Russellville Steel Co. (In re Circuit City Stores Inc.)*, 2012 WL 1981781 at *1.
8 *Id.*
9 *Id.* at *2.
10 The parties stipulated prior to trial that the debtors experienced a liquidity crisis in November 2007. *Id.* at *5, n. 9.
11 *Id.* at *2.
12 *Id.* at *3.
13 *Id.*
14 *Id.* (internal citation omitted).

review of the cases cited by the defendant in support of its position confirmed that while a 12-month period may be appropriate in some circumstances, there was no support for the assertion that a rigid 12-month period was required as a matter of course.[15] The court also noted that the adoption of such a test would impair the court from conducting a flexible analysis required in the Fourth Circuit.[16] Citing *Advo-System Inc. v. Maxway Corp.*,[17] the court emphasized that the Fourth Circuit test required an analysis of transfers as compared to the *preinsolvency* period, *not* a comparison to the pre-preference period.[18] Following *Advo-System*, the court found that none of the transfers, which demonstrated a large shift in payment timing, were ordinary.[19]

Although it may be criticized, a closer look confirms that the approach taken by the court is consistent not only with prior case law, but with the Code itself. Rigidity in the subjective ordinary-course defense has been specifically removed from the Code. Under the ordinary-course defense as established in the Bankruptcy Reform Act of 1978, a defendant could only avail itself if the disputed payment was made within 45 days of the date the obligation was incurred.[20] This 45-day litmus test was removed in 1984.[21] After amendments to § 547 under BAPCPA,[22] the subjective prong was further distanced from any relationship to the objective analysis, as defendants no longer had to prove that transfers were both subjectively and objectively ordinary. Given the purposeful separation of these defenses, it makes more sense now than ever to complete a thorough subjective review of the parties. Despite numerous decisions subsequent to the 1984 amendments lamenting that the "ordinary course" has no statutory definition,[23] Congress has not seen fit to add rigid timelines as clarification. Further, a host of decisions support the view in *Russellville* that the historical baseline should be based on the timeframe in which the debtor was financially healthy.[24] This decision continues the approach established both in the Bankruptcy Code and case law that the subjective ordinary-course-of-business defense requires a flexible approach appropriate to the facts and circumstances of each case. **abi**

15 *Id.*
16 *Id.*
17 37 F.3d 1044 (4th Cir. 1994).
18 *Id.* at *5.
19 *Id.* at *6.

20 As enacted in 1978, § 547(c) provided, in relevant part:
The trustee may not avoid under this section a transfer—....
(2) to the extent that such transfer was—
(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made not later than 45 days after such debt was incurred;
(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
(D) made according to ordinary business terms.
Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2597.
21 *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub.L. 98-353, § 462(c), 98 Stat. 378.
22 PL 109-8, April 20, 2005, 119 Stat 23.
23 *See, e.g., In re Control Elec. Inc.*, 91 B.R. 1010, 1012 (Bankr. N.D. Ga. 1988) (noting that no statutory definition existed for ambiguous "ordinary course of business").
24 *See, e.g., In re Molded Acoustical Products Inc.*, 18 F.3d 217 (3d Cir. 1994) (agreeing with *Tolona* court that important inquiry as to subjective prong was whether transactions were consistent with norm established in period preferably long before preference period); *Matter of Tolona Pizza Prod. Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993) (transfers should "conform to the norm established by the debtor and the creditor in the period before, *preferably well before*, the preference period") (emphasis added); *Moltech Power Sys. v. Tooh Dineh Indus. (In re Moltech Power Sys. Inc.)*, 327 B.R. 675, (Bankr. N.D. Fla. 2005) (some courts have indicated that baseline established should focus on period well before debtor experienced financial problems); *Gonzales v. DPI Food Prod. Co. (In re Furrs Supermarkets Inc.)*, 296 B.R. 33 (Bankr. D.N.M. 2003) (determining comparison of ordinariness should be preferably before debtor starting experiencing financial problems); *Plan Admin. Agent v. Coastal Indus. (In re Kevco Inc.)*, 2005 WL 6443621, *13 (Bankr. N.D. Tex. June 30, 2005) (baseline period should extend back to before debtor became financially distressed to when "ordinary" in layman's terms).