Credit Research Foundation
Education Brief

Prudent Collection Action May Be Hazardous to Your Preference Defense

By: Bruce S. Nathan, Esq. and Michael Papandrea, Esq.

Introduction

If there is one pill tougher for a creditor to swallow than being owed significant indebtedness by a financially distressed customer that has filed a bankruptcy case, it is collecting outstanding invoices from its customer only to later find out those payments are subject to turnover as a preference after its customer's bankruptcy filing. Preference claims continue to plague trade creditors who received payments from a customer within 90 days of the customer's bankruptcy filing because the Bankruptcy Code provides that these payments are subject to disgorgement.

Creditors can reduce their exposure by asserting an array of preference defenses. However, the recent decision of the United States Court of Appeals for the Third Circuit (the "Third Circuit"), in *Burtch v. Prudential Real Estate & Relocation Services, Inc., et al.* ("*Prudential*"), illustrates how a trade creditor's prudent collection efforts ultimately precluded the creditor from proving one of these preference defenses, the ordinary course of business defense, that would have mitigated its preference liability.

Preference Claims & Defenses

Pursuant to section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving all of the following:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but

the most frequent type of transfer is the debtor's payment from its bank account to a creditor [section 547(b)(1)];

- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [section 547(b)(2)];

- The transfer was made when the debtor was insolvent [section 547(b)(3)], which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period;

- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [section 547(b)(4)]; and

- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [section 547(b)(5)].

There are multiple affirmative defenses contained in section 547(c) of the Bankruptcy Code that a creditor can assert to reduce its preference exposure. One of these defenses is the "new value" defense set forth in section 547(c)(4). The new value defense reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the debtor's receipt of an alleged preference payment.

A creditor can also assert the "ordinary course of business" defense to reduce its preference liability. The creditor must first prove the alleged preference payment satisfied a debt that the debtor incurred in the ordinary course of business or financial affairs of the debtor and the creditor. A trade creditor that extended credit to the debtor should have little difficulty satisfying this requirement. The creditor must then prove the preference payment was <u>either</u> (A) made in the ordinary course of business or financial affairs of the debtor and the creditor (frequently referred to as the subjective component of the ordinary course of business defense), <u>or</u> (B) made according to ordinary business terms (frequently referred to as the objective component of the ordinary course of business defense). The subjective element of the ordinary course of business defense was at issue in the *Prudential* case.

A creditor can prove the subjective component of the ordinary course of business defense by showing some consistency between the alleged preference payments and the debtor's and creditor's payment history and other aspects of their relationship. For example, courts may consider the manner, amount and timing of a debtor's payments to a creditor both during and prior to the preference period. Alternatively, a creditor can invoke the objective component of

the ordinary course of business defense by proving the alleged preference payment was consistent with the payment practices and range of terms in the creditor's industry, the debtor's industry, or some subset of either or both.

Congress enacted these preference defenses to encourage creditors to continue doing business with, and extending credit to, financially struggling companies. However, as illustrated by the *Prudential* decision, a creditor might not be able to prove the subjective element of the ordinary course of business defense where the creditor had pressured its financially struggling customer to expedite payment of past due invoices as the price of continuing to do business with that customer.

Factual Background

AE Liquidation, Inc., f/k/a Eclipse Aviation Corporation (the "Debtor"), filed its bankruptcy case on November 25, 2008 (the "Petition Date"). The Debtor's business relationship with the preference defendants, Prudential Real Estate and Relocation Services, Inc. and Prudential Relocation, Inc. (collectively, the "Defendant") began on May 1, 2006, when the Debtor and Defendant entered into a relocation services agreement. The Defendant had agreed to provide certain relocation services to the Debtor's employees and the Debtor agreed to pay the Defendant for those services within 30 days of receipt of an invoice from the Defendant. The Debtor was current in payment of Prudential's invoices from the inception of the Agreement until the summer of 2007.

In the summer of 2007, the Debtor began to fall behind in payment of Defendant's invoices. By November 2007, the Debtor owed $1.7 million to the Defendant on invoices that were over 60 days old. As a result, the Defendant required the Debtor to make payments of approximately $200,000 per week and a lump sum payment of approximately $900,000 by December 2007 to clean up these arrearages (collectively, the "First Payment Plan"). Additionally, the Defendant placed the Debtor on "billing review"— where the Defendant would not accept any new business from the Debtor without having monitored and assessed the Debtor beforehand. From November 26, 2007 to January 2008, the Debtor made weekly payments of approximately $200,000 each and a lump sum payment of approximately $900,000 on January 4, 2008. The Defendant took the Debtor off billing review after the Debtor had complied with the First Payment Plan.

However, by March 2008, the Debtor had again fallen behind in payment of its invoices owing to the Defendant. By August 2008, the Debtor's outstanding balance owed to the Defendant was $800,000—of which $600,000 was past due. Around the same time, the Defendant had learned the Debtor was conserving its cash and had discharged approximately 650 employees and instructed them to submit their pending relocation expenses to the Defendant. In response, the Defendant put the Debtor back on billing review. The Defendant also placed the Debtor on a new payment plan (the "Second Payment Plan") where the Debtor was required to

make weekly payments of $50,000 each to the Defendant and a lump-sum payment for the balance owing by the Debtor.

The Debtor made twelve payments totaling $781,702.61 to the Defendant within 90 days of the Petition Date. These payments included five payments each in the amount of approximately $50,000 in September, 2008 pursuant to the Second Payment Plan. On September 24, 2008, Defendant demanded an increase of the weekly payments to $75,000. When Defendant did not hear back from the Debtor, Defendant sent an email to the Debtor on September 30, 2008 stating "[i]t is critical that we receive a response to our request to increase the weekly payments to bring the account current. If we do not receive a response by close of business tomorrow, 10/1/08, [Defendant] will need to re-evaluate our options, up to and including termination." That same day, the Debtor agreed to pay $75,000 per week to Defendant. As part of this "Amended Payment Plan," the Defendant initiated an entirely new billing practice where it sent a weekly billing summary to the Debtor and did not issue a complete invoice to the Debtor until the Debtor had fully paid the charges in the summary. In October and November, 2008, the Debtor made seven more payments of approximately $75,000 each to Defendant.

The Chapter 7 trustee commenced a lawsuit against Prudential, seeking to avoid and recover the alleged preference payments under section 547 of the Bankruptcy Code. The Defendant asserted both the subjective component of the ordinary course of business and the new value defenses to the Trustee's preference claim.

The Bankruptcy Court held that the Defendant had failed to prove the ordinary course of business defense, and the District Court affirmed this ruling on appeal. Though the Bankruptcy Court initially held the Defendant had satisfied the new value defense, the District Court remanded the matter back to the Bankruptcy Court on the applicability of the new value defense to Defendant's services provided to the Debtor *after* the Petition date. The District Court considered only Defendant's services provided prior to the Petition Date in determining the amount of new value that would reduce Defendant's preference liability. Then, on remand, the Bankruptcy Court reduced the value of the Defendant's new value defense by over fifty percent to include only new value Defendant had provided to the Debtor prior to the Petition Date, consistent with the District Court's ruling. The District Court affirmed the Bankruptcy Court's ruling on appeal.

The Defendant then appealed to the United States Court of Appeals for the Third Circuit.

The Third Circuit's Decision

The Third Circuit affirmed the Bankruptcy Court's holding that the Defendant had not satisfied the ordinary course of business defense, focusing on the subjective element of the defense. Noting that "ordinary course of business" and "ordinary business terms" are not defined in the Bankruptcy Code, the Third Circuit explained that "[o]rdinary terms are those which prevail in

healthy, not moribund, creditor-debtor relationships". The court also noted that "each fact pattern must be examined to assess 'ordinariness' in the context of the relationship of the parties over time" when determining whether payments are made in the ordinary course of business of the Debtor and Defendant.

The Third Circuit agreed with the Bankruptcy Court that the payment terms on which the alleged preference payments were made to the Defendant were not "ordinary" in the context of the Debtor's historical relationship with the Defendant. In doing so, the Third Circuit rejected the Defendant's argument that the alleged preference payments were consistent with the parties' historical relationship because they were made only nineteen days faster than the Debtor's prior payments to the Defendant and all of the payments during the preference period were made within the high/low range of payments (number of days from invoice date to payment date) prior to the preference period. While the Third Circuit did not require an "absolute uniformity" in frequency of payment both prior to and during the preference period as a condition for satisfying the subjective prong of the ordinary course of business defense, the court concluded that the Debtor's quicker payments to the Defendant during the preference period were not consistent with the parties' payment history.

Like the Bankruptcy Court, the Third Circuit was persuaded that the alleged preference payments did not satisfy the ordinary course of business defense and reduce the Defendant's preference liability because the Defendant had demanded a quicker payment schedule after it became aware of the Debtor's financial troubles. The Defendant only imposed the First Payment Plan when the Debtor had fallen behind in its payments to Defendant, and stopped imposing the payment plan when the Debtor became more financially stable. Then, the Defendant imposed the Second Payment Plan and a later more stringent amended payment plan when the Defendant had learned the Debtor had discharged 650 employees and was conserving cash. All of the payment plans were on substantially different terms, weekly and lump sum payments, then the 30-day terms contained in the parties' relocation services agreement.

The Defendant also argued that the Second Payment Plan was not unusual because it was similar to the First Payment Plan, which the parties had agreed to a year before the Debtor's bankruptcy filing. However, the Third Circuit agreed with the Bankruptcy Court's conclusion that "the fact [the Debtor] was placed on a similar accelerated payment plan for three months at sometime [sic] in the past does not make the payment plans ordinary . . . . The First Payment Plan and the Second Payment Plan were not simply a renegotiation of the contract, they were unilateral pressure [tactics] by [the Defendant] on [the Debtor] to assure future payment." The Third Circuit was also persuaded that the preference payments were not made in the ordinary course of business because the Debtor was pressured into making certain of the payments under the final amended payment plan the Defendant had imposed on the Debtor following Defendant's threatened termination of the relocation services agreement.

The Third Circuit also affirmed the District Court's ruling that the new value defense only applies to new value provided prior to the Petition Date. The new value defense does not include post-petition new value the Defendant had provided to the Debtor.

Conclusion

The Third Circuit's *Prudential* decision illustrates a catch-22 that a creditor faces when doing business with a financially distressed company. While it may be prudent for a creditor to pressure a struggling company to hasten the frequency of payment in order to increase recovery on its past due claim, the creditor risks additional preference liability, due to its inability to prove the ordinary course of business defense, in the event the company files for bankruptcy.