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Greetings!

As the dog days of summer are winding down, the first signs of a change in season are upon us. Autumn is approaching and with it comes the unofficial start of Bankruptcy Season as companies begin to evaluate their ability to continue doing business in the coming year. Just as the signs of Autumn approaching often are: dropping temperatures, leaves changing their colors and the stores begin to fill up with Halloween and other holiday décor, there are often signs that a struggling business may be getting ready to file for bankruptcy. As Jordana Renert and Keara Waldron, Lowenstein Sandler LLP, aptly note in the following article originally published by The Credit Research Foundation (CRF), in the Q2, 2022 edition of Perspective by CRF it's important for creditors to be mindful of exposure with a distressed customer but it's also important to be conscious of any substantial change in collection tactics that might open the door for a preferential payment suit. Thank you to the CRF for allowing CCC to share this insightful and educational article with our readers.

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Under Pressure: What Vendors Need to Know About Payment Pressure and its Potential Impact on Preference Liability

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Vendors know too well the warning signs of a customer in distress: slower customer payments, delayed shipments, distress in financial reporting, and rumors that the customer is experiencing financial difficulty and may be headed for bankruptcy. Naturally, under these circumstances, a vendor's priorities shift to ensuring payment of outstanding balances and decreasing future financial exposure. However, where the customer's future involves bankruptcy, vendors should be aware of one countervailing concern: the potential for being sued for a "preference" after the bankruptcy case is filed. As it turns out, the efforts a creditor undertakes to mitigate its credit exposure in the days, weeks, and months prior to a bankruptcy filing may actually increase a creditor's eventual preference exposure.

Section 547 of the Bankruptcy Code permits a trustee or debtor-in-possession to avoid and recover from creditors' payments made within the 90-day period before the bankruptcy filing (the "preference period"). A "preference" is defined by Section 547 of the Bankruptcy Code as payment: (1) on an "antecedent" (meaning a previously incurred – e.g., on account of credit terms) debt; (2) made while the debtor was insolvent; (3) within 90 days of the filing of the bankruptcy (or one year if the creditor is an insider); (4) that allows the creditor to receive more on account of its claim than it would have received had the payment not been made and had the claim been paid through a hypothetical liquidating bankruptcy proceeding. The preference statute is designed to dissuade the debtor and its creditors from engaging in unusual payment practices or collection activities that may result in certain "preferred" creditors being paid at the expense of others.

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Management Team

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Fortunately, the bankruptcy code provides creditors with certain defenses that can be relied upon to defeat a preference action. The most common, and oftentimes most complex, affirmative defense to a preference suit is found in Section 547(c)(2)(A) of the Bankruptcy Code and is referred to as the "subjective ordinary course of business defense," or the "Subjective OCB Defense" for short[1].

The Subjective OCB Defense

As the preference statute is designed to discourage unusual payments in the period leading up to a bankruptcy, the Subjective OCB Defense provides a defense for those transactions that a defendant can prove were ordinary between the parties. The Subjective OCB Defense focuses on how the creditor conducted its business with the debtor historically and protects transactions during the 90-day period that are consistent with the parties' historical dealings.

The Subjective OCB Defense considers a variety of factors, none of which are dispositive, including, but not limited to: (1) the length of time the parties engaged in the type of dealing at issue; (2) whether the payments were in an amount more than usually paid; (3) whether the payments were tendered in a manner different from that of previous payments; (4) whether there was any unusual action by the debtor or creditor to collect on or pay the debt; and (5) whether the creditor did anything else to gain an advantage in light of the debtor's deteriorating financial condition.

Typically, the Subjective OCB Defense focuses on the timing of the preference period payments to ensure such payments are consistent with historical practices between the parties. This analysis starts by identifying a historical period prior to the 90-day period that best represents the ordinary course of business between the parties. This decision involves a number of considerations, including, but not limited to: (1) the proper length of the historical period, (2) whether the historical period should be limited to when the debtor was financially healthy, (3) the appropriate payment metric to compare–i.e., days past invoice issuance date, also known as "days-to-pay" (typically applied when invoice terms remain consistent during the historical and preference periods), or days past invoice due date, also known as "days late" (typically applied if there are different invoice terms during the historical and preference periods), and (4) whether the historical period contains outliers that are not reflective of the parties' ordinary course of business and should be removed. The court will then analyze the historical data to determine what was subjectively ordinary between the parties and compare that baseline to the payments challenged as preferential. In making that comparison, courts employ a variety of analyses, including ranges, averages, standard deviation, buckets, and other analyses, with the goal of providing a fair picture of ordinariness.

In many cases, the analysis ends here. However, timing is not the only factor that courts may consider when analyzing the Subjective OCB Defense. In fact, a review of the recent case law construing the Subjective OCB Defense reveals the importance the parties' *conduct* plays in the applicability of the defense. Specifically, if the court finds that a creditor pressured a debtor into making the payments challenged as preferential (usually referred to as payment pressure), the creditor may lose the ability to fully rely upon the Subjective OCB Defense–regardless of the consistency in timing of the payments.

Similar to the timing analysis, consistency in conduct is also critical to the Subjective OCB Defense. As demonstrated by the recent case law, the analysis of the Subjective OCB Defense changes considerably if the court finds that the parties deviated from prior practices in the manner with which they attempted to collect outstanding payments.

This article first looks at some recent examples of a typical Subjective OCB Defense analysis in the absence of payment pressure. Then we examine some recent decisions dealing with instances of potential payment pressure and how this ultimately impacted the court's analysis and decision concerning the Subjective OCB Defense.

No Pressure Here: A Typical OCB Analysis

Two recent decisions provide good examples of a typical Subjective OCB Defense analysis in the absence of any payment pressure by the creditor.

First, in *Miller v. Exist* (*In re J&M Sales, Inc.*), Adv. Pro. 20-50223 (JTD) (Bankr. D. Del. Mar. 1, 2022), the Delaware Bankruptcy Court considered a preference complaint seeking to recover three transfers by the debtor to a vendor between 354 and 389 days-to-pay[2]. Prior invoices during the historical period were paid between 100 and 430 days-to-pay. In denying the plaintiff's summary judgment motion, the *J&M Sales* court held that it could not conclude at this stage that the alleged preferential payments were not ordinary because they fell within the "total range" of days-to-pay for payments made during the historical period. The total range method that the *J&M Sales* court applied compares the total range of days-to-pay invoices during the historical period with the days-to-pay invoices during the preference period. If the timing of the alleged preferential payments of invoices falls anywhere within the historical range, the alleged preferential payments are protected by the Subjective OCB Defense. The total range method, therefore, allows a defendant to rely upon a very broad range of what a court will consider subjectively ordinary. In applying this analysis, the *J&M Sales* court noted that the plaintiff had failed to explain why any other analysis should apply, thereby implying that, in the absence of a compelling reason not to, a court should apply the total range method, at least at the summary judgment stage.

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In comparison, in *Ryniker v. P. Kaufmann, Inc. (In re Décor Holdings, Inc., et al.)*, Adv. Pro. 21-08040 (REG) (Bankr. E.D.N.Y. Feb. 3, 2022), the Bankruptcy Court for the Eastern District of New York found a compelling reason to reject the total range analysis by noting that the historical period contained certain outlier payments that were not indicative of the ordinary course of business between the parties. The *Décor* court concluded that the result of relying on the total range inclusive of such outliers would result in a historical range that was too broad.

The *Décor* court instead relied on an "average lateness" method, which considers the average timing of payment of invoices made during the historical period and compares it to the average timing of payment of invoices made during the preference period to determine whether there was a material difference between the two averages[3]. Under the average lateness framework, if the difference in averages is not material, all the alleged preferential transfers are protected by the Subjective OCB Defense.

The *Décor* court found that there was no material difference where the historical and preference period averages differed by just seven days, specifically noting that there was no unusual collection activity during the preference period, the manner of payment remained consistent, the debtors never informed the creditor of any financial troubles, and the debtors admitted there was no pressure put on them to pay the defendants more quickly during the preference period. Based on the foregoing, the Décor court concluded that all the alleged preference payments were protected by the Subjective OCB Defense[4].

In each of *J&M Sales* and *Décor*, the court applied a Subjective OCB Defense analysis based on the facts and circumstances the court was addressing. Although the analysis employed by each court differed, one thing was consistent: The courts did not find that either defendant had engaged in any enhanced collection efforts in the period before the bankruptcy.

Payment Pressure: A Matter of Degree?

In comparison, in two recent decisions in the *hhgregg, Inc.*, Chapter 11 case filed in the Bankruptcy Court for the Southern District of Indiana, the court analyzed the Subjective OCB Defense where the respective defendants had engaged in enhanced collection activities before the bankruptcy filing. Taken together, the *hhgregg* decisions provide an excellent example of how a court may interpret enhanced collection efforts and how such efforts may impact the Subjective OCB Defense.

First, in *Official Committee of Unsecured Creditors of Gregg Appliances v. D&H Distributing Company (D&H Distributing)*, Adv. Pro. 17-50282 (Bankr. S.D. Ind. Jan. 13, 2022), the court found that enhanced collection efforts by one of the debtors' key vendors, which included threats to withhold future shipments in the days prior to the bankruptcy filing, constituted "payment pressure" and undercut the defendant's Subjective OCB Defense.

In making its determination, the *D&H Distributing* court first engaged in a typical Subjective OCB Defense timing analysis. In considering the historical dealings between the parties, the court found that the debtors began to experience financial distress in the 10-month period prior to the preference period, and that public disclosures revealing the debtors' financial troubles caused the defendant to reduce the debtors' credit limit and tighten its payment terms in the days both prior to and during the preference period. As this period of financial distress had altered the manner in which the parties previously transacted business, the court excluded the 10-month period from the historical period relied upon when analyzing the Subjective OCB Defense and held that the historical period should instead be limited to when the debtors were financially healthy. Since the parties transacted business on varied terms during the historical period, the court also determined it was appropriate to analyze the historical and preference periods on a days-late rather than days-to-pay basis.

By the numbers, the *D&H Distributing* court found that the timing of payments made during the historical period and the timing of payments made during the preference period were virtually identical, thus demonstrating their ordinariness. However, and critically, the court also found that the vendor engaged in a number of irregular collection pressure activities that resulted in the debtors making the timely payments. These activities included: (1) escalating collection communications to senior management, (2) threatening to withhold shipments unless payments were made, (3) tightening payment terms, and (4) significantly reducing the debtors' credit limit, all at a time when the debtors' need for product was at its greatest. The testimony at trial also demonstrated that the debtors' senior officials advocated for payments to be made to the defendant over other creditors at a time when the debtors were actively managing a liquidity crisis, and that the defendant was paid when others were not. In fact, the defendant's collection activities were so successful that the defendant was actually overpaid as of the petition date.

Noting that while the defendant never withheld shipments, sought guarantees of the debtors or their officers, or threatened to pursue collection of the defendant's claim or litigation, and actually increased sales to the debtors during the debtors' period of financial hardship–all of which weighed in favor of the Subjective OCB Defense–the court was left with the "inescapable conclusion" that the debtors prioritized paying the defendant over other creditors and denied the Subjective OCB Defense.

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Conversely, just a few weeks later, in *Official Committee of Unsecured Creditors of Gregg Appliances, Inc. v. Curtis International Ltd. (Curtis)*, Adv. Pro. 17-50281 (Bankr. S.D. Ind. Feb. 3, 2022) the same court concluded that less successful enhanced collection activity without any threats did not abrogate the application of the Subjective OCB Defense. Similar to the conclusions in *D&H Distributing,* the court in *Curtis* concluded that the defendant increased collection communications both prior to and during the preference period. Specifically, communications became more frequent and insistent during the preference period and began to include senior executives of the respective parties, when historically such communications were confined to their respective credit managers. While the testimony at trial demonstrated that the debtors felt pressure to pay the defendant as a result of the repeated emails, the defendant never made veiled or overt threats to alter its credit or payment terms, reduce the debtors' credit limit, withhold product, or pursue formal collection activity or litigation. On these facts, the *Curtis* court held that, while the tenor of the collections communications between the parties became more persistent during the preference period, the communications did not rise to the level of "unusual collection activity" as they had in *D&H Distributing.* Accordingly, with the exception of the timing of payment of an outlier invoice that was inconsistent with the historical period, the court concluded the Subjective OCB Defense was applicable.

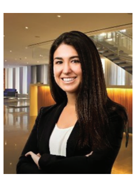
Conclusion

These recent decisions serve as a reminder that the Subjective OCB Defense analysis is often replete with nuance that impacts the ultimate outcome in any given case. For example, while the courts in *J&M Sales* and *Décor* both considered the full extent of the historical period, the court in *D&H Distributing* deemed it appropriate to only consider the history when the debtors were "financially healthy." Moreover, the court in *J&M Sales* focused on a range of days-to-pay, while the court in *Décor* focused primarily on the historical average. Further, the court in *J&M Sales* found it appropriate to apply the total range method, yet the court in *Décor* concluded such an analysis would be inappropriate to the extent it included outlier payments. Finally, the *D&H Distributing* court considered a days-late analysis because of the presence of differing trade terms, and the court in *J&M* instead relied on days-to-pay on similar facts. Thus, the subjectivity of the Subjective OCB Defense makes it very difficult to predict what method of analysis and analytical framework a court will adopt. This unpredictability means that a court's ultimate holding based on the same facts may vary from circuit to circuit, district to district, and even judge to judge.

As demonstrated by the *hhgregg* decisions, however, one critical factor in the ultimate success of the Subjective OCB Defense is whether the defendant engaged in unusual collection activities that rise to the level of "payment pressure," whatever that term may mean. While both *hhgregg* decisions involved enhanced collection efforts on the part of the respective defendants, it was the added threat of taking affirmative action to collect on outstanding balances that ultimately jeopardized the defense in *D&H Distributing.* Even though the payments made during the historical and preference periods in *D&H Distributing* were arguably the most consistent as compared to the other decisions, the fact that the consistency was achieved through "payment pressure" ultimately resulted in limited applicability of the Subjective OCB Defense. Accordingly, while a favored creditor may wield significant power in persuading a distressed company to prioritize paying its outstanding balance, if the court determines that such efforts are sufficiently extraordinary in comparison to the parties' prior practices, such conduct may prove costly and detrimental to a vendor in the event of a preference suit.

While vendors should always take measures to limit their exposure when dealing with a distressed company, they should also be mindful that any substantial deviation from the parties' historical course of conduct–particularly making threats or taking overt action to collect on outstanding balances could come back to haunt them if they are ultimately sued for a preference, which may lead to expensive, unpredictable, and prolonged litigation. To the extent possible, vendors should endeavor to maintain consistency in the method and manner of collection practices if they suspect a customer is headed for bankruptcy.

[1]Section 547(c)(2)(B) provides an objective ordinary course of business defense that is not addressed by this article.
[2] While the court noted that the parties had transacted business on varying terms, the court nonetheless focused on a days-to-pay analysis.
[3] While, as the name suggests, the average lateness method typically considers the average days late, the court in Décor considered the average days-to-pay.
[4] Although this was not critical to the holding, the Décor court also applied a bucketing analysis, which is typically used to determine the ordinariness of a payment based on the frequency with which payments of similar timing were made during the historical period. Even though the Décor court found that approximately 80 percent of the alleged preference payments were made between 31 and 35 days-to-pay compared with only 10 percent of payments that were made within that range during the historical period, the Décor court concluded that such bucketing analysis still supported the Subjective OCB Defense because the timing of the alleged preferential payments was close to the average days-to-pay during the historical period.



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