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Commercial Preference Defendants Rejoice! Reform Has Arrived!

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While most publicity regarding the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) focused on consumer bankruptcy reforms, commercial creditors faced with the vexing problem of a preference action in bankruptcy also received some relief. The most significant change eases the burden on the creditor to establish the ordinary course of business defense. Other provisions preclude the debtor from suing to recover transfers under \$5,850.00, and require lawsuits seeking less than \$11,725.00 total to be brought in the creditor’s home court.¹

Preference Claims and the Ordinary Course of Business Defense

Creditors that have suffered through a customer’s bankruptcy filing know that a double whammy can be involved: First, the customer files its bankruptcy petition leaving a large unpaid balance, resulting in an unsecured claim worth pennies on the dollar. Secondly, often years after the original bankruptcy filing, the debtor or the trustee sues the creditor to recover all payments that the debtor made in the 90 days before the bankruptcy filing—the dreaded preference claim.

The threshold to assert the preference claim is very low. Most debtors sue every company that received a payment within the 90 day preference period, no matter how small. The burden then falls to the creditor to establish some defense. Two of the more common defenses are not altered by BAPCPA: the subsequent new value defense and the contemporaneous exchange defense remain available and powerful tools for defending preference claims. Unfortunately, these defenses rarely provide a complete shield for all payments—usually the creditor must resort to the ordinary course of business defense to protect a portion of the payments received in the preference period. ***This is where BAPCPA has expanded the creditor’s defense.***

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¹ Reflects April 1, 2010 CPI adjustments.

For bankruptcy cases filed before October 17, 2005 (see note regarding effective date, below), the ordinary course of business defense in a preference action has three parts that must be established by the creditor: (1) The payment must have been for a debt incurred in the ordinary course of business; (2) The payment must have been made in the ordinary course of business of the debtor and the creditor; and (3) The payments must have been made according to ordinary business terms. The first requirement is rarely disputed. The second element involves comparing the payment history for the 90-day preference period with the period of time prior to the preference period. If the payment histories for the two periods are generally alike, this is a good indication that this test will be satisfied; however, other factors can also come into play, such as held orders, a switch from checks to wire transfers or other collection efforts. The third element—ordinary business terms—requires evidence that the payments fall within a “range of ordinariness” within the relevant industry.

Most courts require proof of “ordinariness” in the relevant industry to be established by expert testimony – a time consuming and expensive proposition. Debtors often exploit this requirement by resisting the ordinary course of business defense, even in the face of a consistent payment history. Court decisions also have also ruled against creditors that fail to establish this third element.

The New Law – A Broader Ordinary Course Defense

Under BAPCPA the creditor can protect a payment with the ordinary course of business defense by establishing *either* the second element *or* the third element. In other words, the ordinary course of business defense will succeed if a payment was either (a) consistent with the pre-preference period payment history; or (b) made according to ordinary business terms, i.e., ordinary within industry standards.

This change significantly strengthens the hand of the preference defendant. On the one hand, where the preference period payment history does not vary significantly from the prior payment history, debtors will no longer be able to insist on expert testimony to establish that the payment falls within terms ordinary in the industry. And, on the other hand, if the preference period payment history varies significantly from the prior payment history, but falls within industry standards, the payment should still be protected.

The \$5,850.00 Minimum for Preference Claims

BAPCPA also adds a new, bright line defense that prevents the recovery of transfers of less than \$5,850.00. As written, the new law appears to protect individual payments of less than \$5,850.00 from preference attack. This could be especially helpful to those creditors that do a high volume of business with debtors, involving numerous smaller invoices and payments. Even with small, routine payments, the amount of all payments over the 90 day period could be significant, even though no one payment was very large.

Debtors may argue that this provision is only designed to protect the creditor where all payments total less than \$5,850.00, and the creditor that orchestrates a series of \$5,850.00 payments should not be protected. It remains to be seen how the courts will interpret this provision, but it is a potentially significant defense.

The New Venue Provision – Where a Debtor can Sue

Under bankruptcy law applicable to bankruptcy cases filed prior to October 17, 2005, debtors or trustees can file all preference lawsuits in the bankruptcy court where the bankruptcy petition was filed. This has subjected creditors to the prospect of defending even small preference actions in far distant states such as New York, Delaware, or any other, debtor-friendly bankruptcy court around the country. Under BAPCPA, however, where a debtor or trustee seeks an alleged preference of less than \$11,725.00, the debtor or trustee will be forced to sue the creditor in the creditor's home jurisdiction. In other words, even if the debtor or trustee files its bankruptcy case in debtor-friendly Delaware, if it wants to sue a Wisconsin creditor for the return of a preference payment of less than \$11,725.00, it will have to do so in the jurisdiction of that creditor.

As a practical matter, these small preference claims may be eliminated altogether. It is doubtful that most debtors or trustees will want to go to the expense of pursuing such small claims in the courts around the country now that their home court advantage has been eliminated. However, where the debtors or trustees can identify at least two preference payments of \$5,850.00 each, and thereby meet the \$11,725.00 minimum, debtors will still be able to sue in their own local court.

Delayed Effective Date

Because most of the changes in BAPCPA only apply to main bankruptcy cases commenced after the October 17, 2005 effective date of the new law, these changes to the preference defenses have not gone into full effect right away. Because preference actions often are not filed until two years after filing of the main bankruptcy case, preference actions filed in connection with bankruptcy cases commenced before the effective date will still be subject to the old law. However, these new defenses will apply to later bankruptcy cases, and we expect to start seeing these preference claims very soon. Under the adage of "better late than never," these changes are welcome reforms and should help curb some of the more egregious, often frivolous preference claims.



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