

ORDINARY COURSE DEFENSE TO PREFERENCE ACTIONS



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When an organization files a bankruptcy, it can have significant impact on its vendors beyond the obvious lost sales and uncollectable receivables. Vendors can find themselves having to defend certain payments received from a bankrupt entity in the months leading up to the bankruptcy filing.

Debtors in bankruptcy (and trustees) often invoke the avoidance powers of the Bankruptcy Code, particularly the preference provisions under §547. Generally speaking, the purpose of §547 is to avoid certain payments made by the debtor to vendors within the 90-day period preceding the bankruptcy filing (the “preference period”), for pro-rata redistribution to all unsecured creditors of the bankruptcy estate.

Several defenses are available to preference actions. The most commonly asserted of these is the ordinary course of business defense—the subject of this article. The first element of the “ordinary course” defense deals with proving that the transaction between the vendor and debtor that resulted

in the alleged preference was an ordinary business transaction between the parties. This element is usually undisputed since it is based on simple facts about the business relationship between the vendor and debtor.

Proving the other two elements—that the transaction occurred in the ordinary course of business and according to ordinary business terms—require more analysis. As a result of the recent change to Section 547(c)(2) of the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, only one of the two elements must be demonstrated.

To prove that the transaction occurred in the ordinary course of business, an analysis of the debtor’s historical payments to the vendor prior to the preference period is performed to establish the amount of time the debtor has historically taken to pay the vendor. In addition to the timing of the payments, it is also necessary to evaluate whether the payment terms or method changed, or if unusual collection efforts were employed during the preference period. This

analysis is based on the debtor’s and vendor’s business records; however it usually becomes the subject of dispute due to the subjective nature of the analysis.

In cases where ordinary course of business is established based on the industry, an analysis of the terms within the industry is necessary. This analysis includes an examination of the days sales outstanding for the industry from published sources such as Integra or Risk Management Association. It is also useful to have expert testimony from a credit specialist within the industry to corroborate factual information about the industry. The credit specialist can be someone within the vendor’s company or an outside third party engaged by the vendor.

Having an understanding of the ordinary course defense can be a useful tool to evaluate a company’s current credit practices. Identifying and addressing inconsistent credit and payment trends and terms with customers early on can work as an effective measure to avoid becoming a target of a successful preference action. ¹