Fending Off Bankruptcy Preference Claims During Pandemic

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We are living in unprecedented times. As we continue to see the reaction and adjustment to the great shutdown of our economy and world trade, it is important to identify and consider the interpretation of many aspects of the Bankruptcy Code post-pandemic.

Companies should assess the ordinary course of business principle with regard to possible preference exposure if a customer files for bankruptcy, since what was ordinary prepandemic may no longer be so. The new normal that will emerge from the COVID-19 era demands a new approach to business, and that by definition asks the question — what does the post-pandemic ordinary course of business look like?

The Ordinary Course of Business Defense

Creditors need to understand the difference between two independent defenses available under the Bankruptcy Code's ordinary course of business defense.

The subjective test provides that a payment is not a preference if the creditor received the payment in the ordinary course of the debtor's business based on the history and pattern of payments between the creditor and the debtor. The objective test provides that a payment is not a preference if the creditor received the payment in accordance with ordinary business terms based on standard payment practices in the industry in which the creditor and debtor do business.

Historically, a creditor had to satisfy both the subjective and objective tests to successfully defend against a preference action. A 2005 amendment to the Bankruptcy Code changed that by eliminating the need to satisfy both tests. It is now possible to defeat a preference claim under either the subjective or the objective test.

In determining whether a payment is made in the ordinary course of business under the subjective test, courts examine the (1) prior course of dealing between the parties; (2) amount of the payment; (3) timing of the payment; (4) circumstances of the payment; (5) presence of unusual debt collection practices; and (6) changes in the means of payment. Courts scrutinize the time period well before the preference period to establish the baseline for the course of conduct between the parties.

Typically, that time period is at least one year, though it will be shorter if the relationship between the debtor and the creditor is more recent. Courts then look at the time of, amount of, and manner in which the payment occurred. Courts recognize that a creditor can exploit a debtor's financial condition through pressuring a debtor for payment. Unusual collection efforts during the preference period may remove a payment from the scope of the ordinary course of business defense.

The objective test focuses on general practices in the industry, not the specifics of the transaction between the debtor and creditor. The creditor's industry is the measure for ordinariness under this test.

Ordinary business terms for the objective test refers to the general practices of similar industry members. A creditor must show that the terms of the transaction in question were within the recognized boundaries of established industry practice and only dealings that significantly depart from that practice are generally held to be outside the scope of the objective test.

But the test is not rigid. There is no single norm for credit transactions within an industry. The inquiry is whether a particular arrangement so differs from the industry norm that it cannot be said to have been made in the ordinary course of business.

The Problem

Determining whether a creditor has a viable ordinary course of business defense is often imprecise, even in normal times. The dramatic and unprecedented disruption in business activities during the COVID-19 crisis has made that determination much more difficult.

Debtors who were once reliable credit risks and prompt payers now need to renegotiate payment terms or simply defer payments. Creditors, suffering from their own financial distress, are pressuring clients and customers for payment in order to avoid their own financial calamity. It is a vicious cycle affecting a vast swath of businesses in nearly all sectors of the economy.

This raises an important question — does past precedent properly inform us as to what ordinary means in these trying times either between two parties or across an entire industry?

Given the lag time between the filing of a bankruptcy petition and the commencement of preference recovery actions, it unlikely that there will be any judicial decisions on this subject for at least a year or more. Even then there will almost certainly be divergent opinions and it will take much longer for any type of consensus to develop.

Defensive Measures for Creditors

So, what can a creditor today do to minimize its exposure to a potential preference claim, understanding that the traditional methods for determining the ordinary course of business may not fully apply to payments received during the COVID-19 era?

The most effective strategy is to continue to follow the best practices guidelines that applied during the pre-COVID-19 period.

This means creditors should have a documented and consistently applied protocol for dealing with delinquent accounts that is communicated to clients and customers, in writing, at the outset of the relationship; and document and preserve all communications with clients and customers concerning payment issues, including written and electronic communications and notes of telephone conversations.

However, creditors should not compel payment. This does not mean ceasing normal collection practices, but it does mean not making unusual threats that are inconsistent with past practice or established protocols.

Assessing Ordinary in the Industry

There are no bright-line criteria for evaluating industry data used in the objective test. Courts have generally opined that the creditor must only establish that the transfers in question did not deviate significantly from ordinary payment practices observed within the industry. The determination of whether payments are ordinary is informed by certain metrics pertaining to the transfers in question, and comparison to similar metrics observed among industry participants.

One metric commonly relied upon with regard to payment terms within an industry is days sales outstanding, or DSO. Practitioners analyze the transfers in question by calculating the number of days between the invoice date and payment date and then comparing that measurement to industrywide DSO during the relevant time period.

A second metric commonly relied upon is days payables outstanding, or DPO. Practitioners analyze the transfers in question by calculating the number of days between the invoice date and payment date and then compare that measurement to industrywide DPO during the relevant period.

While these metrics may seem similar by their definition, they demonstrate two different aspects of the health of the cash flow of an organization. DSO measures how well an organization manages its cash collections, while DPO measures how well an organization pays its own operating expenses.

The objective test requires the practitioner to analyze publicly available information related to industrywide payment and collection practices — measured in terms of DPO and DSO, respectively. Various research organizations frequently publish data of this nature.

This information is critical to the analysis, allowing for a comparison between the DSO and DPO exhibited by the payment and the DSO and DPO ordinarily observed within the industry. Evaluating the data source is a prerequisite to appropriately applying the objective test. There are several recognized sources of industry-specific data.

Industry Profiles

Industrywide financial information is compiled from multiple sources and relies on the financial performance data of over 4.5 million privately held businesses. The underlying data used to generate reported industry metrics are not discretely accessible in the public domain, inhibiting the extent to which a practitioner can evaluate the resulting conclusions.

Annual Statement Studies

Composite financial statement data is based on more than 250,000 statements from participating institutions that represent the financials from their commercial customers and prospects. The institutions' names are removed before the data is compiled and are not available to third parties.

Publicly Available Financial Data

Global company information and resources for market research that facilitate fundamental analysis can be accessed through publicly available financial statement information, as reported directly from the subject company, rather than through an intermediary.

We are beginning to see the severe effects on clients across industries and geographies to their respective ordinary course of business protocols. The current extended market disruption is a business environment characterized by changes to the ordinary course of business.

By way of example, an international manufacturing client's U.S. subsidiary receives materials from its European affiliate. Prepandemic, payment terms were net 60, meaning that the U.S. entity had 60 days to pay its affiliate before the amount became overdue.

Given the impacts of the pandemic, the European affiliate was forced to change the terms to prepayment, rather than net 60; product would not be released and shipped until payment in full was received. This change created severe consequences for the U.S. entity, as it attempted to manage its own cash flow through the same difficult times.

If the U.S. entity were to file for bankruptcy and seek to recover preferential payments to its European affiliate, would the change to prepayment under the circumstances be considered ordinary, where prepandemic it would not? We would argue that as the U.S. entity continues as a going concern, the ordinary course of business with its primary supplier completely changed given the disruption caused by the pandemic.

How Will the Courts Respond?

In the past, trustees often chased preference recipients en masse based upon a cursory review of the debtor's books and records. If the records showed payments to vendors or other creditors within the 90-day preference period, trustees would send demand letters or sue recipients without evaluating any affirmative defenses.

An amendment to the preference statute in 2019 will hopefully curtail this shoot-from-hip-and-see-what-sticks practice. The statute now requires the trustee to perform reasonable due diligence and take into account a party's known or reasonably knowable affirmative defenses before seeking recovery of a preference.

This amendment has particular resonance in the COVID-19 era. A trustee's decision to sue or not sue is guided by the business judgment rule, which courts generally do not second guess. A trustee evaluating a potential preference recipient's affirmative defense of ordinary course of business now must consider what is ordinary in this environment, given some of the issues we discuss.

The trustee's business judgment will necessarily be informed and shaped by issues such as (1) how an industry has been affected by the coronavirus; (2) a debtor's liquidity, source of capital and ability to make payments to vendors; (3) whether the timing of payments has been changed; and (4) whether the debtor's cash position has impacted its collection efforts and methods.

For instance, if a debtor is forced to draw on a line of credit to make payments because it has no customers and no cash flow and repays the lender within the preference period, will that be considered ordinary? If a debtor previously sent checks every 45 days but now has to wire payment in 60 days, is that now ordinary? If a debtor negotiates the amount and timing of every payment to a vendor, has the ordinary course of business changed?

The trustee is the gatekeeper; in the first instance, she will exercise business judgment to decide if the new normal is sufficient to establish ordinary course. What nobody can know is how sympathy or empathy may impact a trustee's choices. After all, the trustee is human. Even though a trustee could sue, should she?

The trustee has the burden of proving that a preferential transfer is avoidable and the defendant has the burden of proving its defenses. Courts will be looking at preference claims after the trustee has made an initial evaluation of ordinary course defenses.

Will a court infer or assume that a trustee has concluded that a defendant does not have a provable defense? Should the court even draw this conclusion?

It may well turn out that bankruptcy judges will consider the ordinary course of business analysis that previously applied to now be effectively suspended because so many payments will be out of the ordinary course that disrupted payments are, at least temporarily, the new definition of ordinary. We simply will not know until some of the preference actions wind their way through the courts and result in judicial decisions.

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