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Archway vs. Ames: Do Debtor's Activities with Other Creditors Affect Subjective § 547(c)(2)(A) Safe Harbor?

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Two bankruptcy courts have recently addressed the issue of whether a debtor's activities with creditors in general can affect the ordinary-course-of-business defense under the subjective prong of § 547(c)(2)(A) of the Bankruptcy Code. In the first decision, *Ames Merch. Corp. v. Revere Mills Inc. (In re Ames Dept. Stores Inc.)*, [2] the bankruptcy court seemed to hold that debtor conduct such as holding checks and deciding which creditors to pay may take transactions with all creditors out of the ordinary

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course of business, regardless of the conduct with the specific preference defendant. In the second decision, *Burtch v. Detroit Forming Inc. (In re Archway Cookies)*, [3] the bankruptcy court held that the debtor's holding and voiding of checks by itself will not defeat an ordinary-course-of-business defense where such conduct did not apply to the specific preference defendant.

Ordinary-Course-of-Business Defense

One of the defenses that a preference defendant may assert is the ordinary-course-of-business defense under § 547(c)(2) of the Bankruptcy Code. Under the ordinary-course-of-business defense, the creditor has the burden [4] of proving that the transfer was "payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was (A) made in the ordinary course of business or financial affairs of the debtor and the transferee, or (B) made according to ordinary business terms." [5] Prong (A) is often referred to as the "subjective test," [6] while prong (B) is referred to as the "objective test." When conducting the subjective test, courts often look to the following five factors:

(1) the length of time the parties engaged in the type of dealing at issue; (2) whether the subject transfers were in an amount more than usually paid; (3) whether the payments at issue were tendered in a manner different from previous payments; (4) whether there appears to have been an unusual action by the debtor or creditor to collect on or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as gain additional security) in light of the debtor's deteriorating financial condition. [7]

For the first factor, there is no specific length of time required to show that the preference-period transactions are ordinary. [8] On the second factor, a plain comparison between the size of the transfers in the preference period and historical period are examined. [9] In looking at the third factor, a court compares the method of payment (*i.e.*, cash, check, certified check or wire), [10] as well as the timing of the payment to determine whether it remained consistent during the preference

period. Courts have held that small deviations in the timing of payments do not take payments out of the ordinary course of business. As with the length of time required to analyze a history, there is no hard-and-fast rule regarding how large a deviation is too large to be considered ordinary. [11]

Regarding the fourth factor, courts have looked at various collection activities, including:

(1) changes in the credit terms on which the parties conducted business; (2) letters, telephone calls or any attempts on the creditor's part to apply pressure or to "dun" debtor to encourage more prompt payment; (3) attempts by the creditor to change delivery terms; (4) threats or intimidation by the creditor, direct or indirect; and (5) attempts by the creditor to institute legal action to collect amounts owed to it. [12] With respect to the fifth factor, courts have focused on whether the creditor required the debtor to post a security deposit. [13]

Ames Decision

In *Ames*, the debtor filed a complaint against a trade vendor seeking avoidance and recovery of various wire and check transfers as alleged preferences. [14] The wire transfers totaled \$913,892.08, while the check transfers totaled \$259,872.40. [15] By stipulation of the parties, the net preference for check transfers was reduced to \$61,843.60 because of new value. [16] After holding that the wire transfers were either not on account of antecedent debt or, alternatively, were contemporaneous exchanges for new value falling under the § 547(c)(1) defense, [17] the court addressed the ordinary-course-of-business defense as it pertained to the check transfers.

In considering the ordinary-course-of-business defense, Hon. Robert Gerber noted that the check payment system utilized by the debtors changed in the months leading up to the bankruptcy. Beginning in May 2001 and coinciding with the preference period, in response to a lack of liquidity the debtors ceased sending checks automatically as they were printed. [18] Instead, executives of the debtors convened daily meetings to discuss funds availability and which "payments to disburse, which to delay, which to accelerate, which to pay partially and which not to pay at all." [19]

Judge Gerber held that there was no “recitation of relevant facts” relating to the ordinary-course-of-business defense for the check transfers, and since the debtor “broke with its ordinary business practices by retaining the checks and deciding who should and should not be paid, rather than mailing the checks as they were printed when payment became due,” [20] the check transfers did not qualify for the § 547(c)(2) ordinary-course-of-business defense. While the decision did not specify whether the checks at issue were affected by the debtor’s change in payment practices, a review of the trial transcript revealed that there was specific testimony from an Ames employee that “instead of being promptly mailed to Revere [the checks] were then held by Ames because we lacked available funds to satisfy the checks.” [21]

***Archway* Decision**

In *Archway*, the chapter 7 trustee filed a complaint asserting that a trade vendor had received \$180,646.17 in preferential transfers that were subject to avoidance and recovery. [22] By stipulation, the net preference was reduced to \$68,672.28 after application of new value. [23] The only outstanding issue was whether the transfers were protected from avoidance by the ordinary-course-of-business defense.

In asserting the ordinary-course-of-business defense in a motion for summary judgment, the defendant presented evidence that the parties had a two-year relationship of similar-type transactions both in size and method of payment (check), and that the timing of the payments was consistent for the historical period and preference period. [24] The trustee opposed the defendant’s motion for summary judgment and presented evidence that argued that the court must look at the debtor’s own actions, which included “holding checks, voiding checks and preferring certain vendors over other vendors, among other payment practices reflecting the Debtors’ distressed financial status.” [25] The trustee argued that the fact that the debtors employed such tactics with other creditors, but could not with the creditor at issue, was evidence that the creditor had been preferred.

[26] However, Hon. Christopher Sontchi rejected the trustee's argument, holding that "the subjective test reviews the transactions between the debtor and defendant, not a debtor's transactions with all of its creditors." [27]

Judge Sontchi also rejected the trustee's argument that the defendant "pressured the Debtors into payment during the Preference Period by requiring payments on past due invoices before shipment of new goods were made, by requiring the Debtors to pay down its outstanding balances during the Preference Period, by informing the Debtors that expedited payment would result in expedited shipments of goods, and by sending the Debtors a list of past due invoices." [28] In doing so, he noted that while the tactics listed by the trustee in isolation are the tactics that the preference statute was designed to solve, when these tactics are "consistent with the historical dealings" between the parties, they do not take the parties out of the ordinary course of business. [29] Accordingly, the court granted the defendant's motion for summary judgment based on the subjective prong of the ordinary-course-of-business defense.

Conclusion

Based on a review of *Ames* and *Archway*, when a creditor is capable of presenting credible evidence regarding the length of time, similarity between transactions, timing of payments and lack of unusual action between the parties in receiving the transfers, a creditor may be able to defeat a trustee's argument that the debtor's change in payment process and/or holding or voiding of checks took all transfers out of the subjective ordinary-course-of-business safe harbor.

1. The views expressed in this article are those of the authors and may not reflect the views of the firm.
2. 2010 WL 2403104 (Bankr. S.D.N.Y. June 10, 2010).

3. 435 B.R. 235, 241-42 (Bankr. D. Del. 2010).

4. See 11 U.S.C. § 547(g).

5. 11 U.S.C. § 547(c)(2). Following the passage of Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), a creditor only needs to prove prong (A) or (B) of § 547(c)(2). See *Wahoski v. Classic Packaging Company (In re Pillowtex)*, 427 B.R. 301, 303 n.3 (Bankr. D. Del. 2010) (noting that while BAPCPA became effective on Oct. 17, 2005, any bankruptcy proceeding that commenced before that date would operate under pre-BAPCPA Bankruptcy Code, even if particular adversary proceeding was commenced after that date).

6. See, e.g., *Montgomery Ward v. OTC International Ltd. (In re Montgomery Ward)*, 348 B.R. 662, 672 (Bankr. D. Del. 2006); *The Unsecured Creditors' Committee on Behalf of the Debtors' Estates v. Air Products & Chemicals Inc. (In re Color Tile Holdings Inc.)*, 2000 Bankr. LEXIS 835 (Bankr. D. Del. 2000).

7. *Archway Cookies*, 435 B.R. at 241-42 (citing *In re Forklift LP Corp.*, 340 B.R. 735, 738-39 (D. Del. 2006)); see also *Pillowtex*, 427 B.R. at 306 (listing same factors to be considered).

8. For instance, the Third Circuit affirmed an ordinary-course finding on an analysis of one year prior to the preference period. *Troisio v. E.B. Eddy Forest Prods. Ltd. (In re Global Tissue LLC)*, 106 Fed. Appx. 99, 102 (3d Cir. 2004).

9. See *Archway Cookies*, 345 B.R. at 243.

10. See *Fonda Group v. Marcus Travel (In re Fonda Group)*, 108 B.R. 956, 961 (Bankr. D. N.J. 1989) (payment by certified check rather than regular check, which was customary between parties was outside ordinary course of dealings).

11. *Ice Cream Liquidation Inc. v. Fabricon Products Inc. (In re Ice Cream Liquidation Inc.)*, Adv.

Pro. No. 03-3175, 2005 Bankr. LEXIS 704, 2005 WL 976935 (Bankr. D. Conn. 2005) (five-day discrepancy between average days outstanding during pre-preference period vs. during preference period did not make payments out of ordinary course of business); *Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.)*, 182 B.R. 728 (Bankr. W.D. Va. 1995) (difference between approximately 54 days pre-preference average days to payment and approximately 67 days preference average days to payment did not make the payments out of ordinary course of business); *Branch v. Ropes & Gray (In re Bank of New England Corp.)*, 161 B.R. 557 (Bankr. D. Mass. 1993) (difference between 38.4 days pre-preference average number of days to payment and 54.7 days preference average number of days to payment did not make payments out of ordinary course of business); *but see Radnor Holdings Corp. v. PPT Consulting LLC (In re Radnor Holdings Corp.)*, Case No. 06-10894, 2009 Bankr. LEXIS 1815, at *15 (Bankr. D. Del. July 9, 2009) (average number of days to payment nearly doubled between historical period and preference period, which, based on facts of that particular case, made payments outside ordinary course of dealings between plaintiff and defendant); *Hunter v. Amerisource Corp. (In re Parkview Hospital)*, 213 B.R. 509, 516 (Bankr. N.D. Ohio 1997), *aff'd*, 181 F.3d 103 (6th Cir. 1999) (payments made 25 days after average were within ordinary course of dealings, but payments made 50 days after average were not).

12. See *Hechinger Liquidation Trust v. James Austin Co. (In re Hechinger Inv. Co. of Del. Inc.)*, 320 B.R. 541, 549 (Bankr. D. Del. 2005); *Logan Square East v. Peco Energy Co. (In re Logan Square East)*, 254 B.R. 850, 855-56 (Bankr. E.D. Pa. 2000).

13. See *In re Logan Square East*, 254 B.R. at 856.

14. *Ames*, 2010 WL 2403104 at *1.

15. *Id.* at *7-8.

16. *Id.* at *8.

17. *Id.* at *13.

18. *Id.* at *9.

19. *Id.*

20. *Id.* at *27-28.

21. Trial Transcript at p. 12:7-10.

22. *Ames* at 238.

23. *Id.*

24. *Id.* at 242-44.

25. *Id.* at 244.

26. *Id.*

27. *Id.*

28. *Id.* at 244-45.

29. *Id.* at 245.