



Valuable and Cost Effective Approaches to Bankruptcy Preference Analyses – Ordinary Course Defenses

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Agenda

- I. Background
- II. Ordinary Between the Parties – Valuable and Cost Effective Approaches
- III. Ordinary In the Industry – Valuable and Cost Effective Approaches
- IV. Other Defenses Available to Creditors
- V. Conclusion: Bringing it All Together



I. Background



I. Background

- Section 547 of the Bankruptcy Code provides several defenses to creditors including:
 - Ordinary Course defenses
 - New Value and Contemporaneous Exchange defenses
- Post-BAPCPA defense to preference claims importantly provides an “OR” requirement with respect the ordinary course defense
 - It is only necessary to prove the transfers occurred consistent with ordinary course in the industry OR between the parties
 - Both ordinary course defenses can be completed in an efficient and cost effective manner
 - Both approaches can be utilized to complement one another

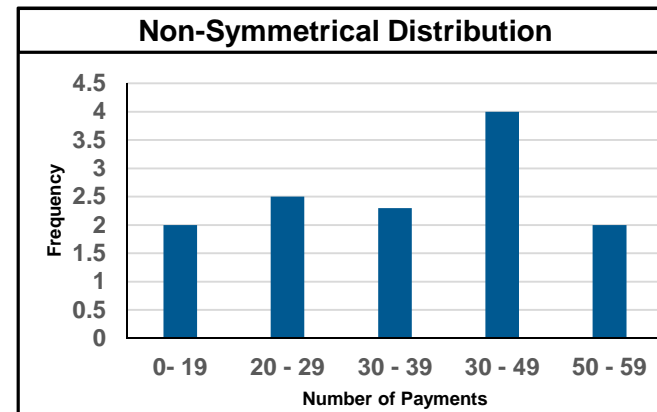
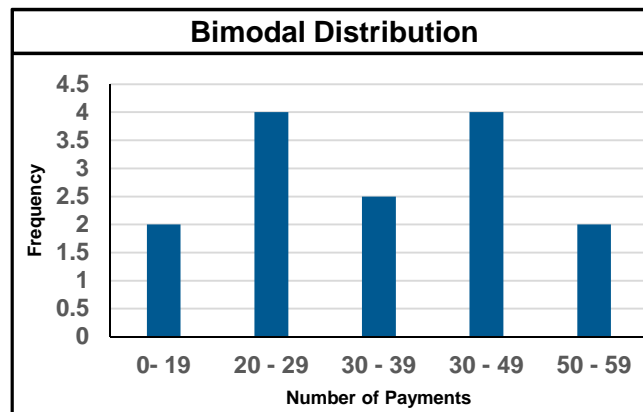
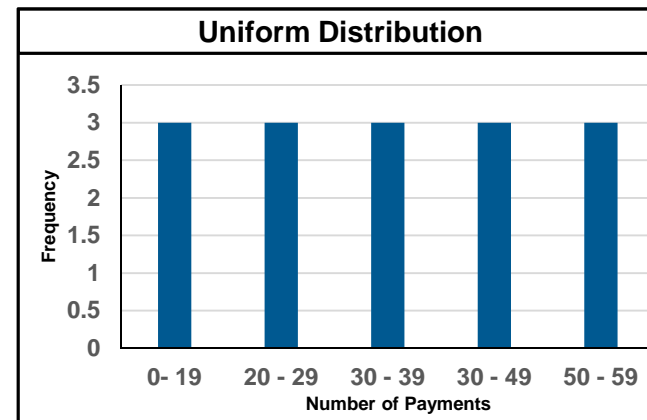
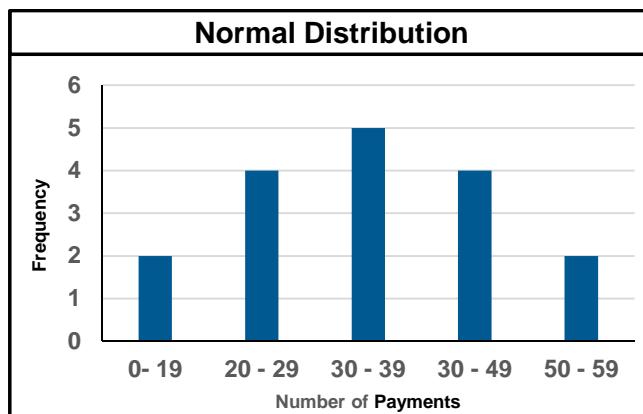


I. Background

- Descriptive Statistics:
 - **Mean**: sum of a list of numbers, divided by the number of numbers.
 - **Average**: usually denotes the arithmetic mean, but it can also denote the median, the mode, the geometric mean, and weighted means, among other things.
 - **Median**: "Middle value" of a list. The smallest number such that at least half the numbers in the list are no greater than it.
 - **Standard Deviation**: measurement of the spread of data around the mean.



I. Background





I. Background

- Recent decisions provide insight into ordinary between the parties:
 - *In re: Clean Burn Fuels, LLC v. Sampson-Bladen Oil Company, Inc.*
 - 12 shipments and six payments, over a seventh month period was “sufficient to allow the court to discern a pattern of ordinary conduct”
 - Average invoice during the baseline period was 39 days outstanding, while the average invoice during the preference period was only 29 days outstanding
 - “While this circumstance alone may not be decisive, it weighs against the Defendant's position that the [payment] was made in the ordinary course of business.”
 - *In re: Conex Holdings, LLC, et al. v Southern Steel Supply, L.L.C.*
 - Relationship began within the 90 day preference period, making it “impossible for the Court to compare the [preference period] transfers...to any transfers in a ...historical period...[y]et there does not appear to have been unusual action...to collect on or to pay the debt, respectively, with the exception of the last payment...”
 - The first ten invoices were paid within the Net 30 payment terms; remaining 11 invoices averaged 42 days outstanding.
 - The Defendant argued that “late payments were tolerated” in their course of dealings.
 - However, the court found that: “[s]eeing as the first ten invoices were paid within the payment terms, and only the last eleven payments were made late, late payments cannot be considered as an ordinary practice between the two parties, despite the allegations otherwise.”



II. Ordinary Between the Parties – The Subjective Test -Valuable and Cost Effective Approaches



II. Ordinary Between the Parties

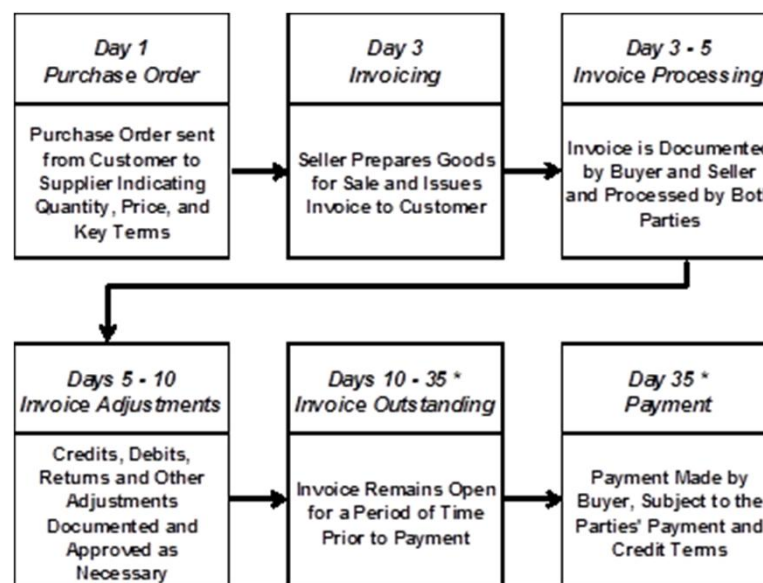
- Issues commonly considered by courts in determining whether the alleged preferential transfers were ordinary include, but are not limited to
 - The length of time the parties were engaged in the transaction at issue;
 - Whether the amount or form of the transfer differed from past practices;
 - Whether the debtor or creditor engaged in any unusual collection or payment activity; and
 - Whether the creditor took advantage of the debtor's deteriorating financial condition.



II. Ordinary Between the Parties

- Common factors that may be important to consider with respect to “ordinary between the parties”

- Establishing the relevant, ordinary pre-preference time period
- Accounting and invoicing systems
- Changes in payment methods
- Changes in payment terms
- Credits and return adjustments



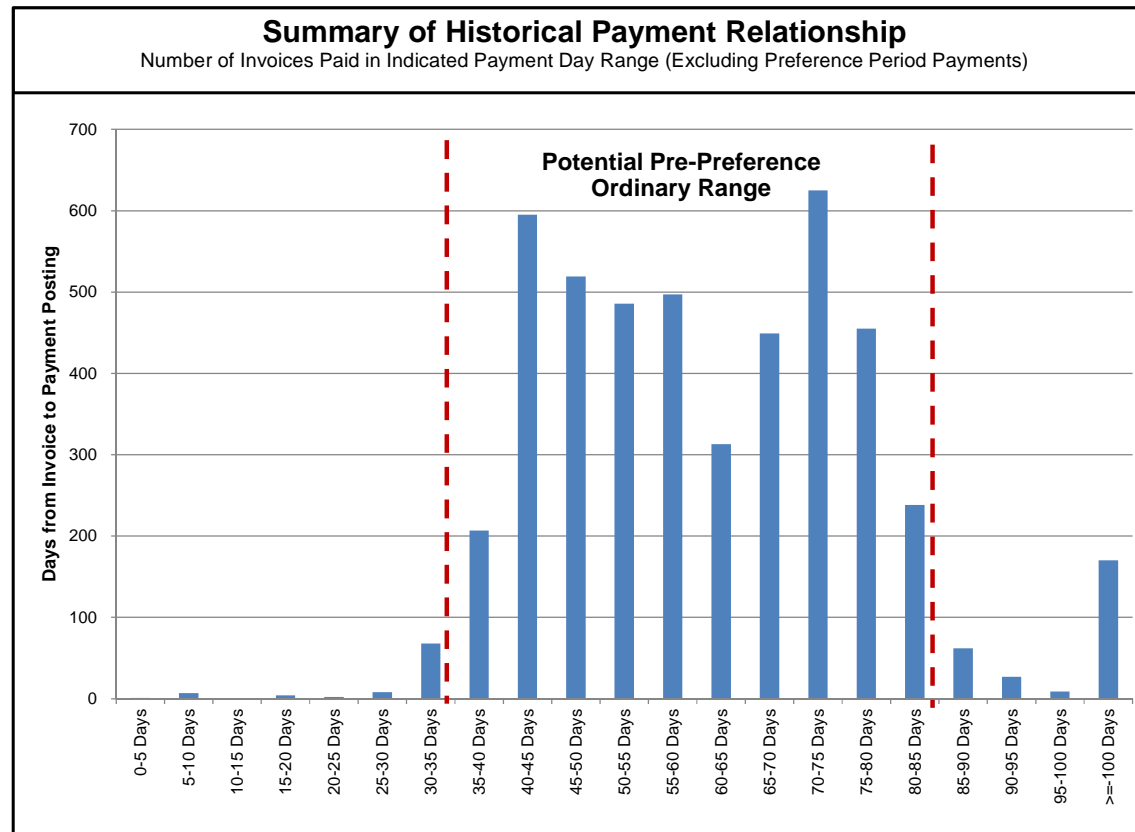
* Note: This is a hypothetical example assuming 30-day payment terms

- An understanding of the overall invoicing and payment process and how it may affect observed payment behavior is important and may inform the overall analysis



II. Ordinary Between the Parties

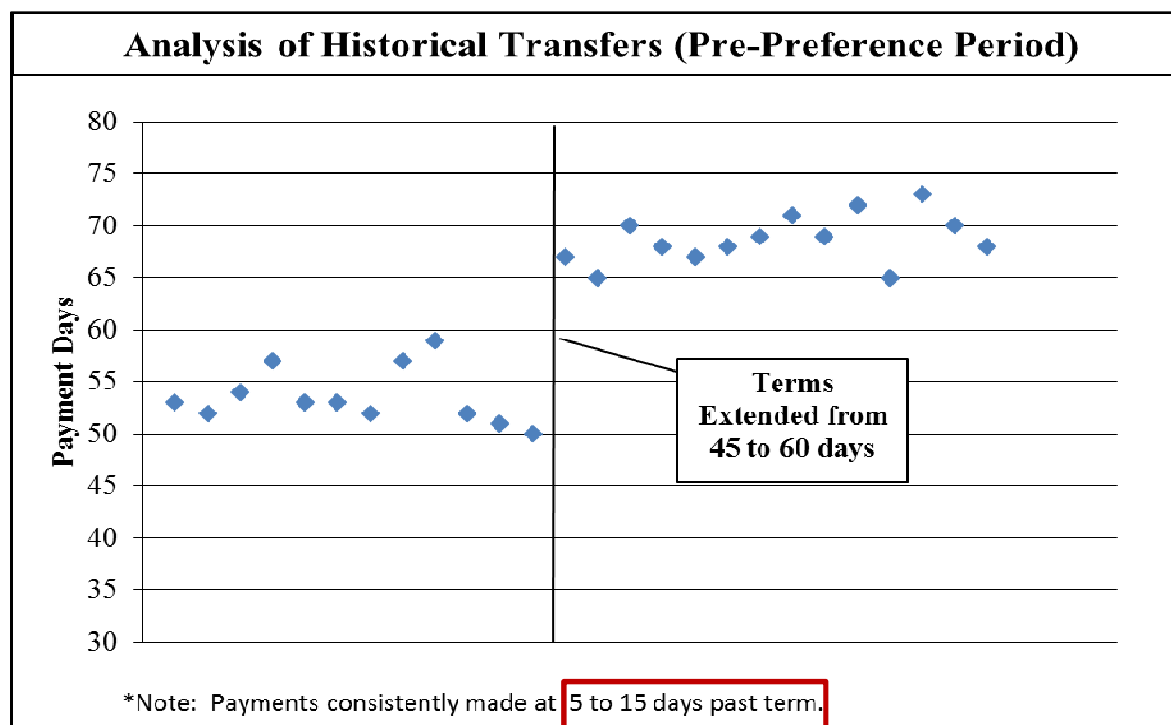
- Establishing the pre-preference payment behavior is an important first step





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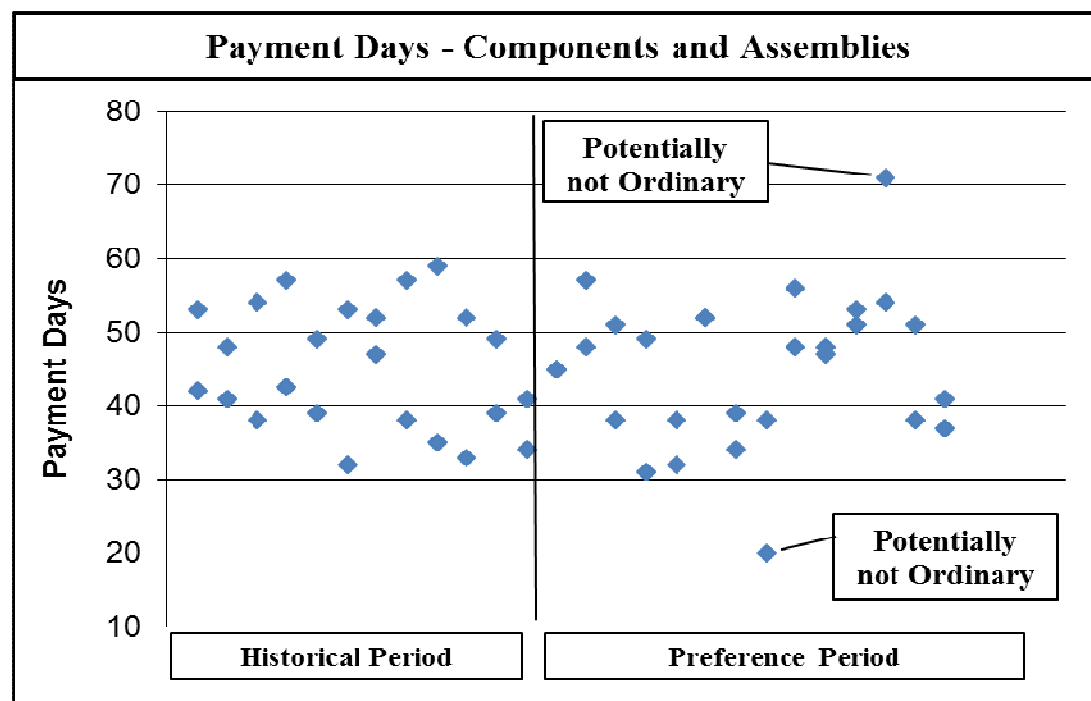
- Establishing the pre-preference payment behavior is an important first step
 - May require consideration of changes that may have occurred in the parties' relationship





II. Ordinary Between the Parties

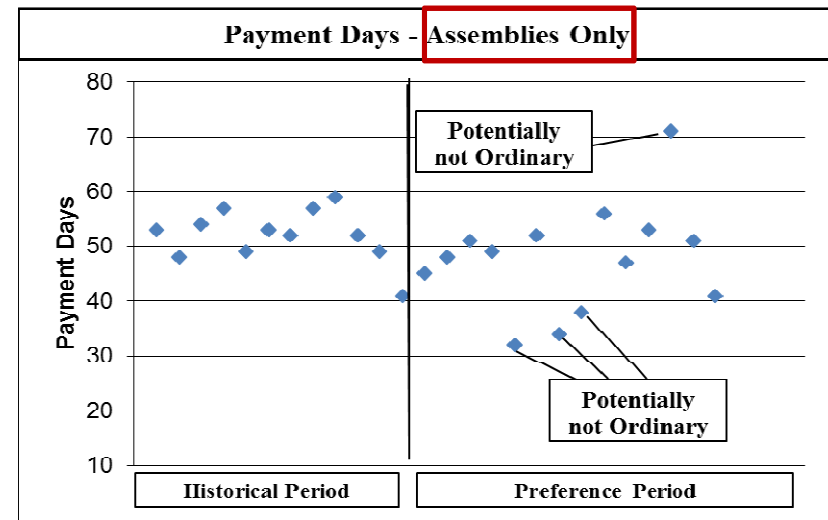
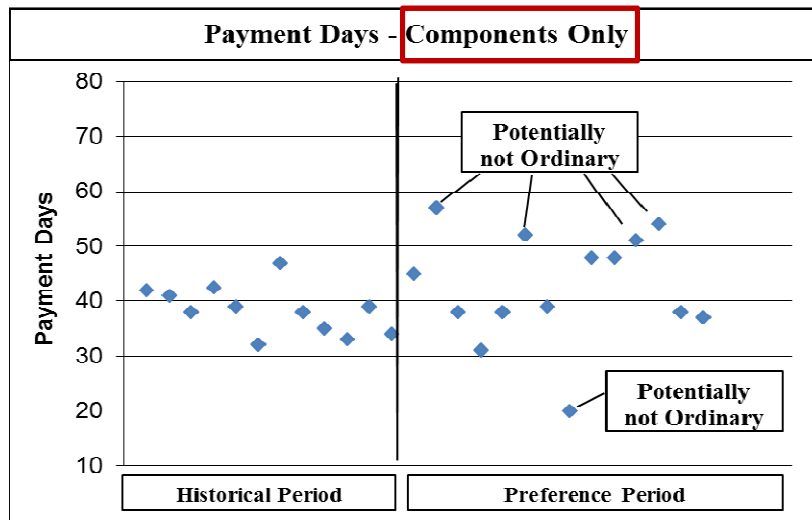
- Once established, the pre-preference behavior may be compared to preference period behavior





II. Ordinary Between the Parties

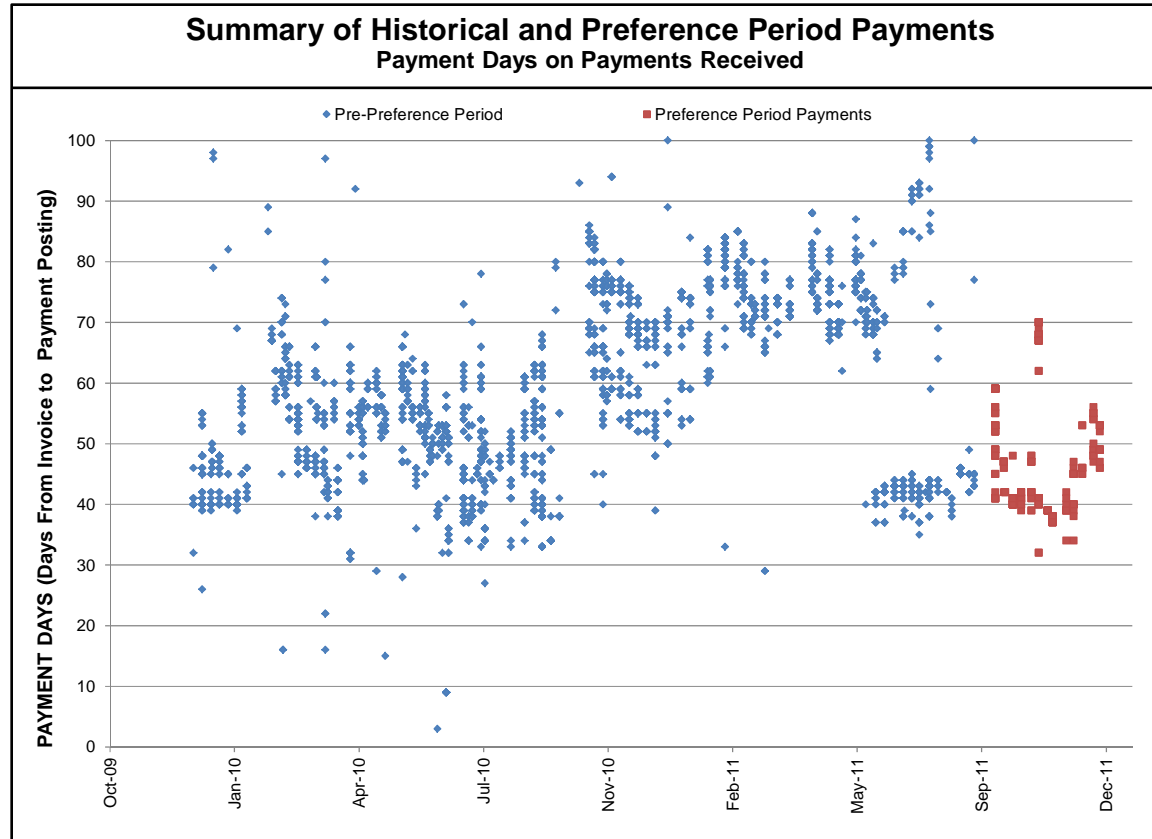
- Once established, the pre-preference behavior may be compared to preference period behavior
 - Unique factors may be important to consider for each alleged transfer





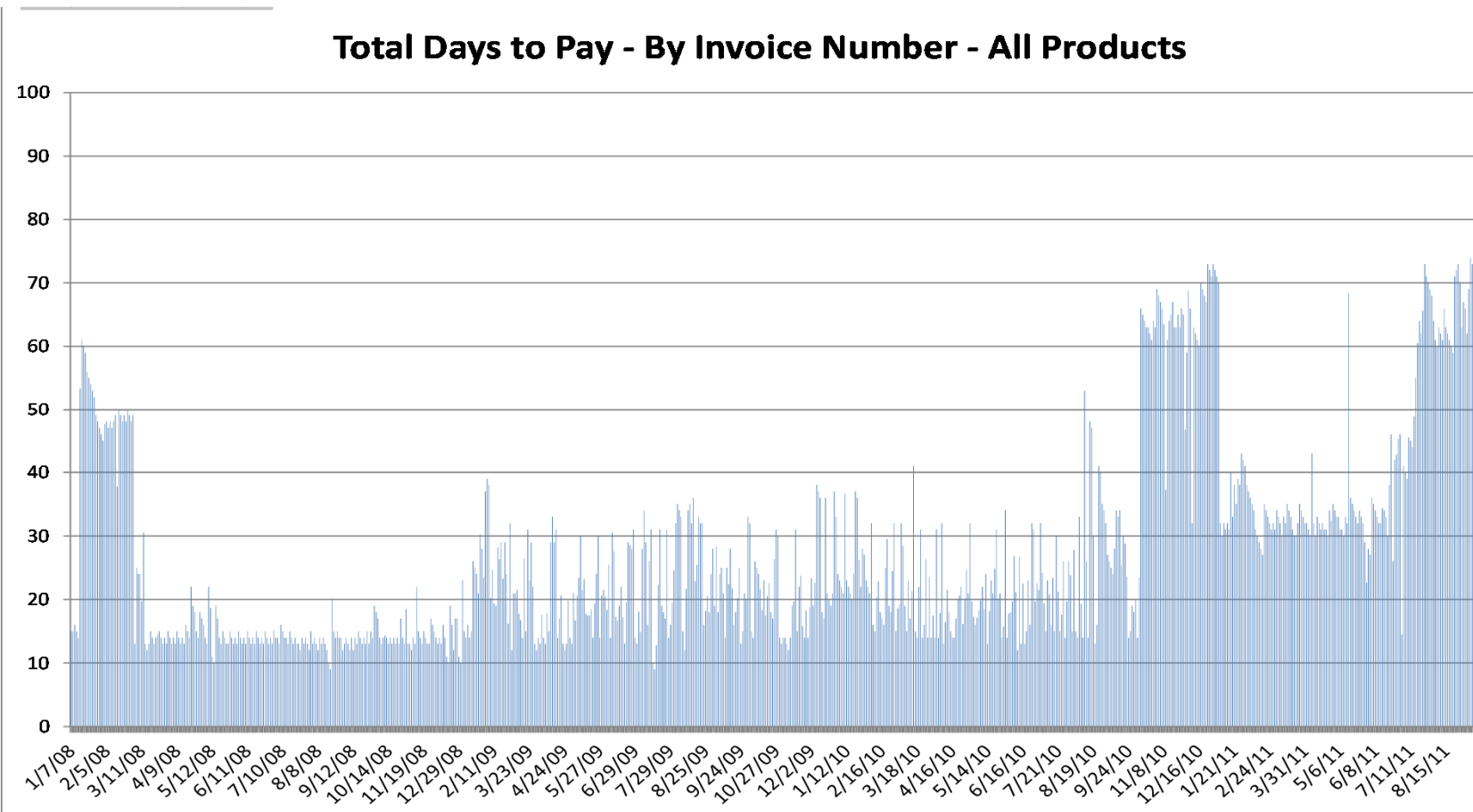
III. Ordinary In the Industry – Valuable and Cost Effective Approaches

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III. Ordinary In the Industry – Valuable and Cost Effective Approaches





III. Ordinary In the Industry – The Objective Test - Valuable and Cost Effective Approaches



III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- Commonly considered metrics in Industry Ordinary Course defense

- **Payment Days**

- Simply the elapsed time between the issuance of an invoice and its payment

$$\text{Payment Days} = \text{Payment Date} - \text{Invoice Date}$$

- **Days Sales Outstanding**

- Gives an approximation of average number of days invoices are outstanding
 - Can be calculated by weighted average method or by turnover method

$$\begin{array}{l} \text{Days Sales Outstanding} \\ \text{(Turnover Method)} \end{array} = \frac{\text{Days in Period}}{\text{Period Sales/ Average Accounts Receivable}}$$

- **Days Payables Outstanding**

- Similar methodology as calculating Days Sales Outstanding

$$\begin{array}{l} \text{Days Payables Outstanding} \\ \text{(Turnover Method)} \end{array} = \frac{\text{Days in Period}}{\text{Period Cost of Sales/ Average Accounts Payable}}$$

- NOTE: Although these metrics may be highly correlated, a direct comparison of these metrics should not be the sole determinant of whether the questionable payments are “ordinary”



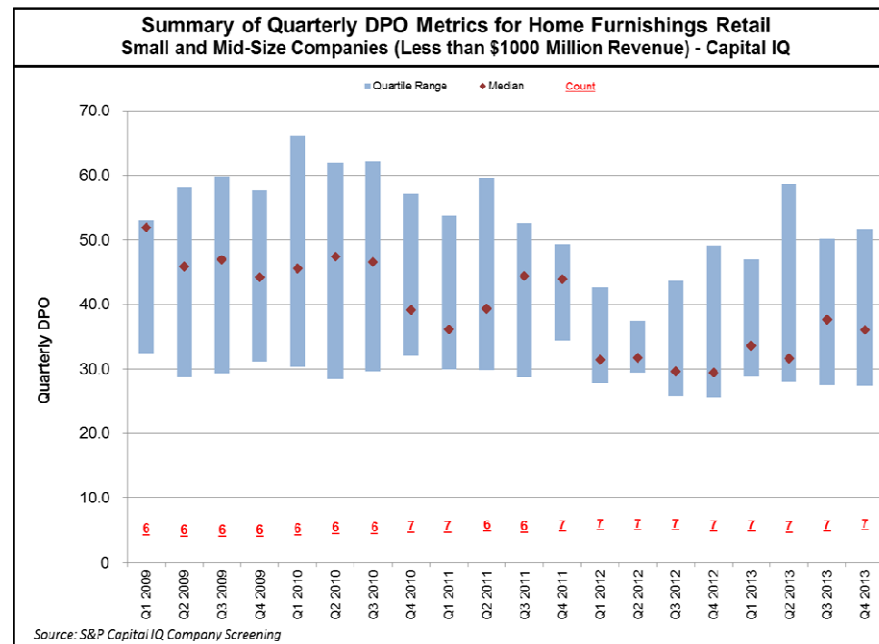
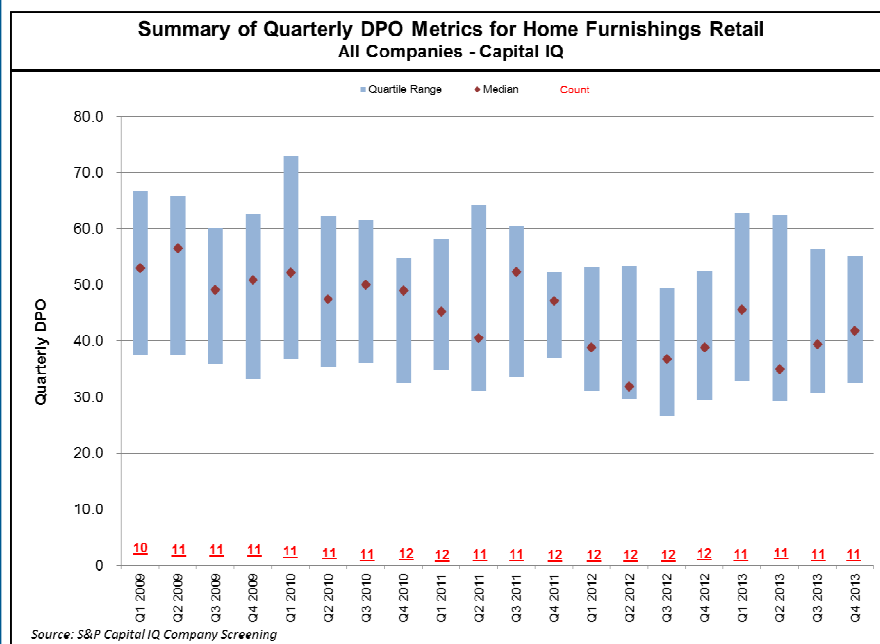
III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- Publicly available sources can be referenced to define payment practices for the relevant industry
 - The extent of the analysis can be customized depending on the scope/ budget and amounts at issue
 - At a minimum, sources such as Risk Management Association (RMA), National Credit Research Foundation (NCRF) and Capital IQ can be consulted with limited effort to develop an understanding of industry payment practices
 - Depending on scope and budget, sources such as Sage Works, AnalyzeThisBusiness, Integra, Dun & Bradstreet, and other sources may also be considered
 - NOTE: sources vary in their sampling and compilation methodology and in the level of detail reported. Such differences should be considered in developing conclusions based on information from different sources.



III. Ordinary In the Industry – Valuable and Cost Effective Approaches

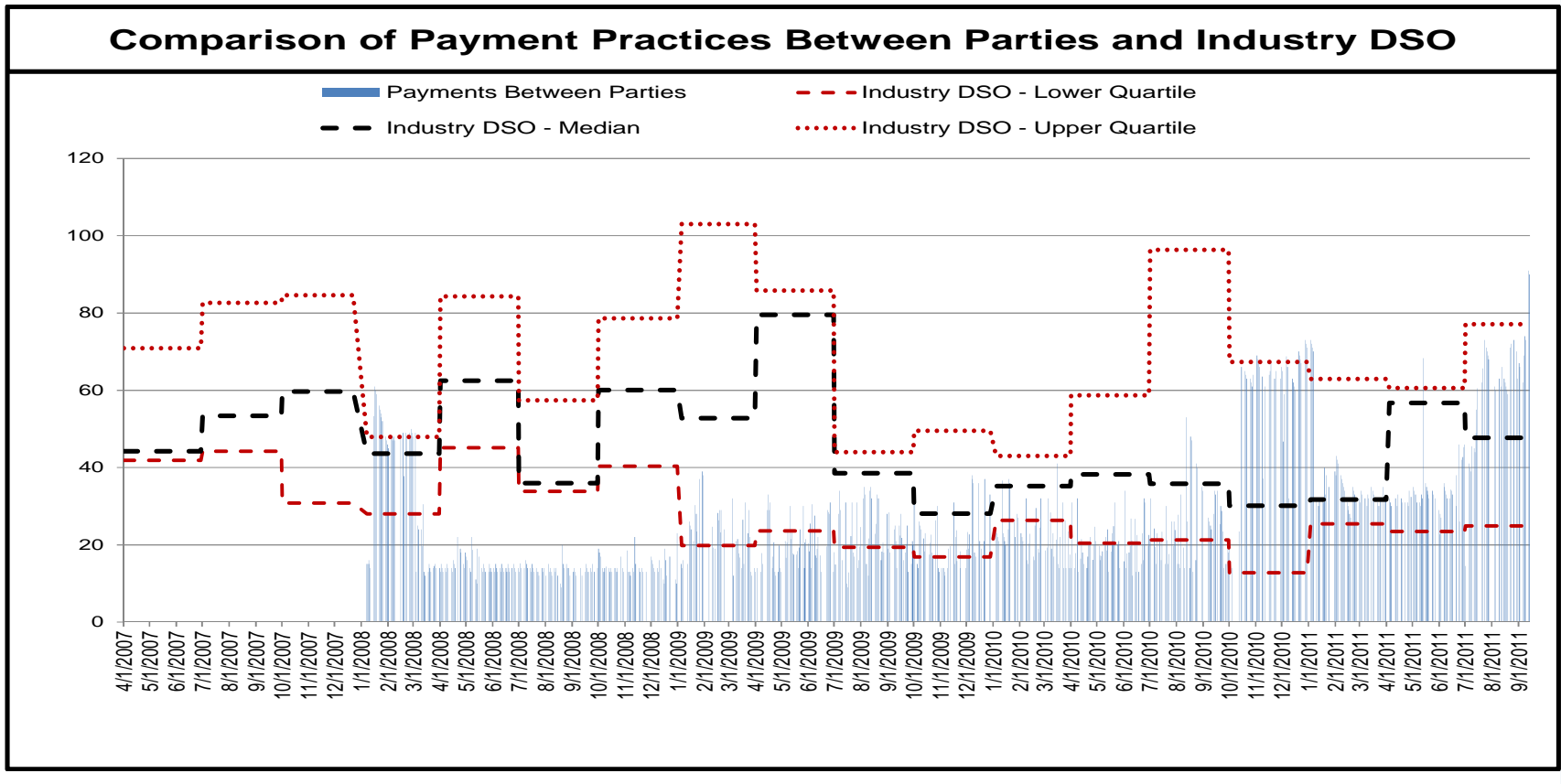
- The distribution of publicly-reported payment metrics can be analyzed to establish ordinary industry payment practices





III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- Overlaying industry information with actual payment history in visual representations can reveal unexpected findings





III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- In most cases, data is available from the debtor or creditor that may allow for an additional dataset to define the relevant industry
 - Payment receipt history data for all other customers of the creditor
 - Payments made by the debtor to similar vendors
 - This information may be utilized as an alternative to define the “industry”
- For more complex matters or matters with more significant amounts at stake, additional research can be performed
 - Industry reports, trade association data, and general research relating to industry trends, influential forces, and other factors that may impact the payment behavior in the industry or result in seasonal or cyclical variations
 - Even in less complex matters or with lower amounts in dispute, some level of such research may still be performed



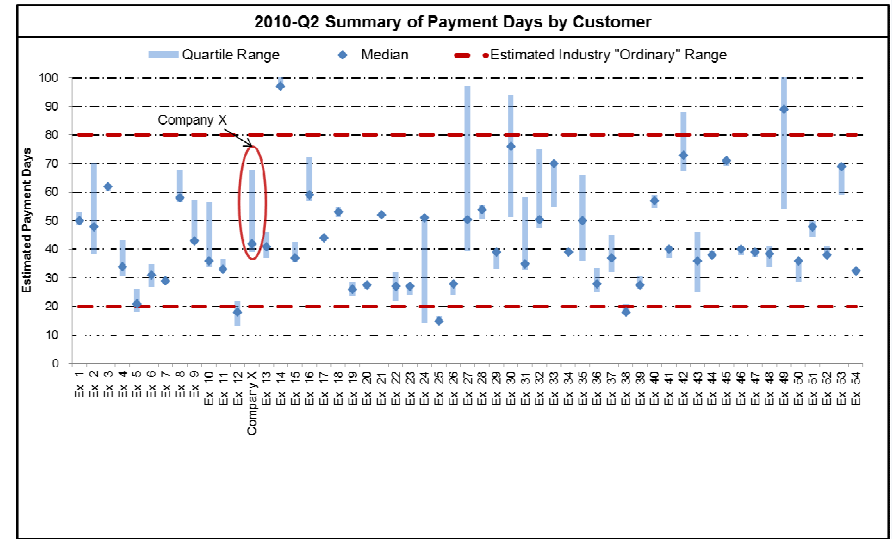
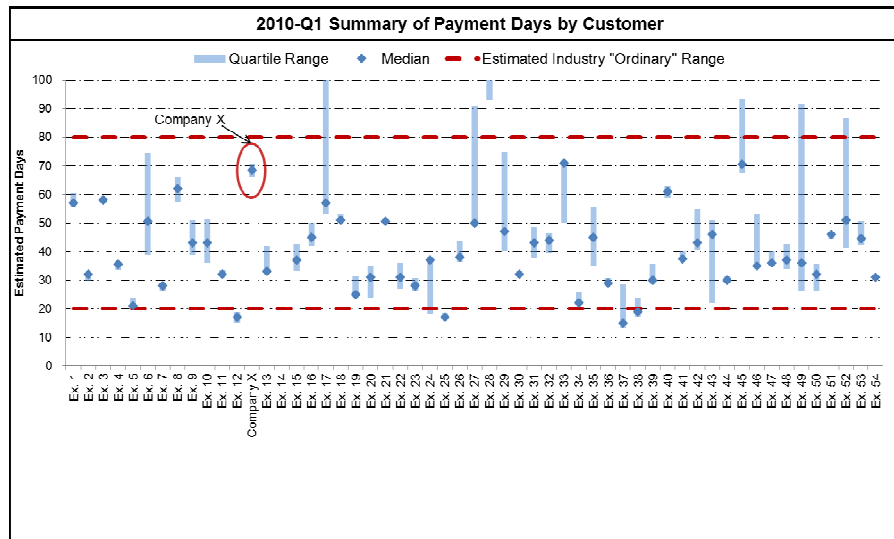
III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- When performing additional analysis, it is important to have an in depth understanding of the comparable companies used to establish an “ordinary within the industry” defense
 - Understand how many sample companies are being used for the analysis
 - Appreciate that there will inevitably be a relatively small sample size, often only 50% of the population
- One common example is the restaurant industry:
 - “Ordinary” terms may vary – e.g., COD, 15 days, 30 days.
 - Additional analysis into industry nuances is necessary to establish ordinary.



III. Ordinary In the Industry – Valuable and Cost Effective Approaches

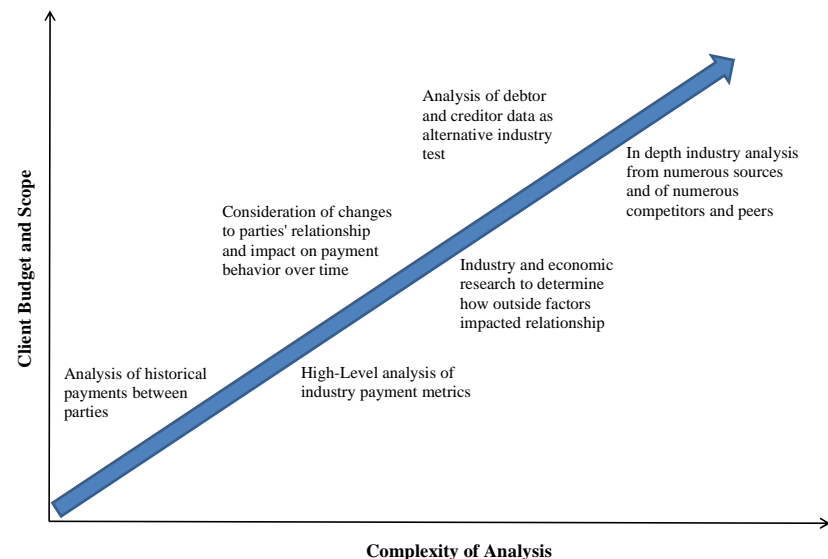
- Data available from Creditor or Debtor may allow for an additional dataset to define the relevant industry





III. Ordinary In the Industry – Valuable and Cost Effective Approaches

- Payments need to be an aberration to be considered “non-ordinary”
 - “[t]he ‘clear consensus’ among the other courts of appeals [is] that the definition of ‘ordinary business terms’ [under section 547(c)(2)(C)] means that the transaction was not so unusual as to render it an aberration in the relevant industry.”
 - Gaining an understanding of the reasonable range of “ordinary” in the industry (and conversely, “aberrations”) can often be assessed quickly and in a cost-effective manner
- Regardless of budget or amount in dispute, an industry ordinary course analysis can be customized to the matter and offer a valuable secondary defense in bankruptcy preference actions





IV. Other Defenses Available to Creditors



V. Other Defenses Available to Creditors

- Other defenses available to the creditor include:
 - **Contemporaneous Exchange for New Value:** The debtor cannot avoid transfers to the extent the transfers were “intended by the debtor and the creditor... to be a contemporaneous exchange for new value given to the debtor.”
 - **New Value Defense:** The debtor cannot avoid the alleged transfer “to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor...” that was “(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer....”
 - **Administrative Priority Claim:** Grants trade creditors a priority claim for the value of goods they had sold to the debtor in the ordinary course of the debtor’s business and that the debtor had received within 20 days of bankruptcy.
- Oftentimes, a “waterfall” approach may be utilized
 - Payments are first analyzed based on the ordinary course defenses
 - Resulting “potentially non-ordinary” payments may then be analyzed to determine if there was associated new value given



V. Conclusion: Bringing it All Together



V. Bringing it all Together

- The defense of a preference claim is often aided by consideration of multiple defenses including the Ordinary Course as well as New Value and Contemporaneous Exchange defenses
 - Each approach requires careful consideration to the facts of the matter and the nature of the payments in dispute
 - Due to the Or requirement, each approach can complement the others and result in more of the alleged transfers being established as non-preferential
- Industry ordinary course defense is often less-utilized for fear of significant cost and complexity
 - While a significant amount of research may be required for complex matters, in many cases limited research leads to a reasonable determination of industry ordinary course
 - With the aid of a financial expert, a preliminary industry ordinary course analysis can often be completed for only several thousand dollars in professional fees
 - A complete expert report can often be completed in a similar cost-effective manner