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Bankruptcy Preferences and the Ordinary Course Defense: Recent Decision Rescues Supplier

Suppliers and vendors sometimes find themselves unpleasantly surprised by the bankruptcy of a customer, leaving a trail of unpaid invoices and little hope of recovery. To make matters worse, after licking their wounds and recovering from the write-off, they may receive an even less welcome surprise—a letter from the bankruptcy trustee demanding money back for the bills that actually did get paid within 90 days prior to the customer's bankruptcy. The only good news is that there are some defenses to such a claim. In a recent decision, *The Unsecured Creditors Comm. of Sparrer Sausage, Inc. v. Jason Foods, Inc.*, No. 15-2356 (7th Cir. Jun. 10, 2016), the United States Court of Appeals for the Seventh Circuit eliminated most of the exposure faced by the supplier, who had been sued for a preference, when it concluded that lower courts had misapplied the ordinary course of business defense the supplier had raised below.

Preference claims are a popular source of recovery in bankruptcy cases, and a complaint is often filed against any vendor who received payments from a debtor in the 90 days preceding a bankruptcy filing. Generally speaking, these payments can be recovered to permit a pro rata distribution to include creditors who were not "preferred" by payment during the 90-day window. But preferential payments may not be recoverable by a debtor at all if the payments it received fit into the ordinary course of business defense. That's not as simple as it sounds, and timing can be everything when analyzing the availability of the defense. The court will review how long it took to pay the invoices during the 90 days to decide whether the payments fit into the ordinary practices and experience of the supplier and the customer during better times. If they do fit, they probably will not be recovered, but if the time it took to pay them differed significantly from prior practice, the ordinary course of business defense likely will not work.

Sparrer Sausage had paid 23 invoices from Jason Foods, totaling $586,658.10, during the 90 days before Sparrer Sausage filed bankruptcy. When Jason Foods was sued to return these payments, it argued that the payments were made in the ordinary course of business. The bankruptcy court considered the ordinary course defense by analyzing the payment history between the parties before Sparrer Sausage's financial distress began. Employing what is called the "average-lateness" method, the bankruptcy court determined that, before Sparrer Sausage's financial distress began, it paid invoices issued by Jason Foods within 22 days and that, therefore, payments made between 16 and 28 days of an invoice fell within an acceptable range and were protected as payments made in the ordinary course. The bankruptcy court concluded that $306,110.23 of the payments to Jason Foods were made outside the ordinary course of business. After deducting $63,514.91 from this amount, for goods supplied by Jason Foods for which the debtor had not paid (utilizing another defense, "new value"), judgment entered against Jason Foods for $242,595.32.

Jason Foods appealed and the Seventh Circuit determined that the bankruptcy court sliced too thin when setting a time frame within which payments would be considered ordinary course. The court noted that Sparrer Sausage paid the vast majority of invoices within 14 to 30 days of issuance. There was no reason, for example, to conclude that payments made 14 days after issuance of an invoice were outside the ordinary course when the timing of those payments fit within the most common pattern during the course of Sparrer Sausage's predistress relationship with Jason Foods. The Seventh Circuit noted that 88 percent of the payments made by Sparrer Sausage fell within, or just outside, the 14- to-30 day range. According to the Seventh Circuit, the narrower range employed by the bankruptcy court was arbitrary and failed to serve the purpose of the ordinary course defense,

which is to protect "recurrent transactions that generally adhere to the terms of a well-established commercial relationship."

Consistently monitoring customers' payment habits for changes and requiring customers to remain within standard payment terms may help set the table for an ordinary course defense in the event of a customer's bankruptcy; however, as Sparrer Sausage demonstrates, the ordinary course defense is quite subjective and intended to accommodate normal patterns of commerce long established between suppliers and their customers. In the event of a customer's financial distress, there are other reliable means of avoiding losses on preference claims. Suppliers who anticipate a customer's distress may wish to consider arrangements such as third-party guarantees, cash on delivery, or letters of credit to continue supplying goods.

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