Timing is Everything: The Seventh Circuit Clarifies the Ordinary Course of Business Preference Defense

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In bankruptcy preference litigation, timing issues are crucial. Was a pre-bankruptcy payment made inside or outside of the 90 day preference period? Was new value given by the recipient of the payment to the debtor before or after receipt of payment, thereby providing a defense to avoidabilty? Was the payment received in the preference period within a range that would constitute ordinary course based upon the parties' course of dealing prior to the 90-day preference period?

In a recent decision, The Unsecured Creditors Committee of Sparrer Sausage Co. v. Jason's Foods, Inc.,[1] the Seventh Circuit Court of Appeals provided some useful guidance on the application of Bankruptcy Code section 547(c)(2)[2], the ordinary course of business preference defense. In Sparrer, the Seventh Circuit addressed the following issues: (1) whether a bankruptcy court could appropriately truncate the number of transactions that establish the prepreference historical period range constituting ordinary course against which the alleged preference is measured; (2) the available methods to establish the historical period range; and (3) the appropriate application of the method, once selected. The bankruptcy court found that the defendant was liable for avoidable preferences totaling in excess of $300,000, a decision which was affirmed by the district court. Based upon its analysis, the Seventh Circuit reversed, reducing the defendant's preference exposure to zero after applying the new value defense.

In its decision, the Seventh Circuit noted that the "subjective ordinary-course defense asks whether the payments the debtor made to the creditor during the preference period are consistent with the parties' practice before the preference period,"[3] citing the court's prior decision, In re Tolona Pizza Products Corp.[4] The test entails using the parties' prepreference period payment history to calculate a baseline for the parties' dealings and then comparing the preference period payments to that baseline.[5]

The Seventh Circuit also noted that calculating the baseline payment practices between the debtor and the creditor requires identifying a historical period that reflects the companies' typical payment practices, which should reflect payment practices before the onset of any financial distress.[6] Although the parties in Sparrer stipulated to a historical period of February 2, 2010 to November 7, 2011, the bankruptcy court rejected the stipulation and considered only a truncated payment history up to April 15, 2011, citing the lateness of payments after that date. Overruling the plaintiff's objection that the decision to truncate the period was inappropriate, the Seventh Circuit, while questioning the bankruptcy court's decision to disregard the parties' stipulation, nonetheless found that the record supported the bankruptcy court's decision because the percentage of invoices paid in 30 or more days after April 16, 2011 jumped nearly 40%.[7]

The Seventh Circuit then turned to the method the bankruptcy court used to determine the baseline historical range of payments against which the alleged preference payments were measured. Citing In re Quebecor World (USA), Inc.,[8] the Seventh Circuit noted that bankruptcy courts generally use two methods to calculate the prepreference period baseline range of payments. The first, the total-range method, uses the minimum and maximum invoice ages during the historical period to establish the range. While the court noted that this method provides a complete picture of the parties' relationship, it has been criticized because it has a tendency to skew the range by payments that are outliers.[9] As an alternative to the total-range method, bankruptcy courts use the average-lateness method, which uses the average invoice age during the historical period to determine which payments made during the preference period were in the ordinary course of business. This method may provide a more accurate depiction of ordinary course because it compensates for outlier payments.

In Sparrer, the bankruptcy court used the average-lateness method to establish the baseline range, even though none of the payments made during the historical period appeared to be extreme outliers. Rejecting the defendant's contention that the bankruptcy court should have used the total-range method, the Seventh Circuit held that the bankruptcy court's determination that the average lateness method better captured the parties' prepreference period payment relationship was sound and should not be upset.[10]

However, the Seventh Circuit found that the bankruptcy court's application of the average lateness method was problematic. The bankruptcy court determined that the average invoice age rose from 22 days to 27 days during the preference period. The Seventh Circuit expressed skepticism that a five day difference in the average invoice age was substantial enough to take a payment out of the ordinary course of business exception of Bankruptcy Code section 547(c)(2). However, given the "fact-intensive, context specific nature of the ordinary-course defense," the court was unwilling to upset the bankruptcy court's decision on this basis.[11]

However, the bankruptcy court's conclusion that invoices paid more than 6 days on either side of the 22 day average were outside of the ordinary course was clear error. While the bankruptcy court used the Quebecor World "bucketing analysis" to support its conclusion, the facts in the two cases were very different. In Quebecor World, the average invoice age during the historical period was 27.56 days, whereas during the preference period, the average invoice age was 57.16 days—a nearly 30 day difference. Because of this disparity, the Quebecor World court grouped the historical-period invoices in buckets, revealing that 88% of them were paid between 11 and 40 days. Consequently, the Quebecor World court concluded that it was appropriate to expand the upper range to 45 days, making payments made 46 days or thereafter avoidable. By contrast, the Sparrer court's historical range of 16 to 28 days, for which it offered no explanation, encompassed only 64% of the historical transactions. Adding 2 days to either side of the range, or a range of 14 to 30 days, captured 88% of the historical period transactions, which was much more in line with Quebecor World. The Seventh Circuit therefore concluded that the Sparrer court's range was not only too narrow, but was arbitrary. For those reasons, the Seventh Circuit reversed the bankruptcy court's decision.[12]

The Sparrer decision provides some useful guidance regarding the application of the ordinary course of business exception to preference avoidability under Code section 547(c)(2). First, it instructs that the prepreference historical period can be truncated after the point the debtor experiences financial distress. Additionally, the Seventh Circuit appears to permit bankruptcy courts the discretion to use either the total-range method or the average-lateness method to determine the payment range that constitutes ordinary course of business within the prepreference period historical range. However, courts must use a range that captures the majority of transactions in the historical period or risk having their conclusions overturned as arbitrary.

It will be interesting to see whether bankruptcy courts will interpret the decision to expand the ordinary course of business defense to preference avoidance, making it more difficult to recover preferential transfers. This is particularly important because in many cases, the debtor's assets are fully encumbered, and preference collections often provide the only source of recovery for creditors.

[1] *Unsecured Creditors Comm. of Sparrer Sausage Co. v. Jason's Foods, Inc.,* No. 15-2356, 2016 WL 3213096 (7th Cir. June 10, 2016).

[2] 11 U.S.C. §§ 101-1532 (the "Code").

[3] *Sparrer,* 2016 WL 3213096 at *2.

[4] *In re Tolona Pizza Prods. Corp.,* 3 F.3d 1029, 1032 (7th Cir. 1993).

[5] *Sparrer,* 2016 WL 3213096 at *2.

[6] *Id.* at *3.

[7] *Id.*

[8] *In re Quebecor World (USA), Inc.,* 491 B.R. 379 (Bankr. S.D.N.Y. 2013).

[9] *Sparrer,* 2016 WL 3213096 at *4.

[10] *Id.*

[11] *Id.*

[12] *Id.* at *5.