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Feature

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Ordinary-Course Decision Raises "Preinsolvency" Transfer Issues

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Editor's Note: *For another viewpoint on this case, see the feature on page 56.*

The court's opinion in *Siegel v. Russellville Steel (In re Circuit City Stores Inc.)*[1] is relatively short and seems innocuous. However, the seemingly straightforward decision may be a trap for unwary plaintiffs and defendants.

The facts may be distilled as follows: the debtor, Circuit City Stores Inc., was a large retailer of consumer electronics that filed for bankruptcy on Nov. 10, 2008. The trustee of the liquidating trust subsequently brought suit against the defendant to avoid four transfers aggregating $124,261, which were made 189, 51, 45 and 46 days after the invoice date,[2] and the defendant raised the ordinary-course-of-business defense.[3] After briefing and oral argument premised on stipulated facts, the court ruled that the payments made by the debtor to the defendant during the 90 days immediately prior to the petition date were preferential transfers, which were not excepted from avoidance under the ordinary-course-of-business defense. Accordingly, the court entered judgment against the defendant in the amount of $124,261.

Among the most salient of the stipulated facts was that, beginning in November 2007, the debtor "experienced a significant change in its liquidity that caused it to delay making payments to its vendors." Between the consummation of the parties' relationship and November 2007, which the court defined as the "liquidity event," the debtor remitted 44 payments to the defendant. Excluding five payments that "drastically deviated," the average length of time to pay those invoices was 33.4 days (with payments made between 31-41 days after the invoice). Between the liquidity event and the beginning of the preference period, and excluding one outlier, the debtor made 37 transfers to the defendant that averaged 46.74 days after invoice (with payments made between 44 and 51 days after the invoice).[4] Nowhere in the court's opinion was there any discussion of any demands for payment, threats of dunning or withholding of shipments, or predating or postdating of checks; rather, the only issue analyzed was the number of days to pay.

The initial, threshold legal issue addressed by the court was the universe of payments to be used to consider the ordinary course of the parties. The trustee argued that the court should consider the entirety of the relationship between the debtor and the defendant "to determine the benchmark from which to measure whether the preference payments were made in the ordinary course of the parties' conduct."[5] In contrast, the defendant argued that the court should adopt a 12-month look-back period immediately preceding the preference period.[6] Ultimately, however, the court rejected both arguments and looked exclusively at only those transfers made prior to the liquidity event.[7]

The court's basis for limiting its analysis to those transfers made prior to the liquidity event was the decision in *Advo-System Inc. v. Maxway Corp.*,[8] the leading Fourth Circuit case addressing the ordi-

1 2012 WL 1981781 (Bankr. E.D. Va. June 1, 2012).
2 The defendant conceded that the payment made 189 days after the invoice was made outside the ordinary course of business.
3 The defendant did not argue that the transfers were made according to ordinary business terms (the objective test set forth at 11 U.S.C. § 547(C)(2)(B)). *Id.* at *3, n. 7. Accordingly, the only issue was whether the transfers made to the defendant during the preference period were made in the ordinary course of business or financial affairs of the debtor and the defendant (the subjective test set forth at 11 U.S.C. § 547(C)(2)(A)).
4 *Id.* at *2.
5 *Id.*
6 *Id.* at *4.
7 The court rejected the defendant's argument, calling a fixed 12-month look-back period "arbitrary" and stating that "such an approach would ignore the Fourth Circuit's observation that the ordinary-course inquiry is 'particularly factual.'" *Id.* (citing *Harman v. First Am. Bank of Md. (In re Jeffrey Bigelow Design Grp. Inc.)*, 956 F.2d 479, 486 (4th Cir. 1992)).
8 37 F.3d 1044 (4th Cir. 1994).

nary-course-of-business defense.[9] In *Advo-System*, the court of appeals addressed the pre-Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) ordinary-course-of-business defense, and adopted a sliding-scale[10] analysis.[11] Prior to *Advo-System*, the court of appeals for the Fourth Circuit had not adopted a rule of construction as to the objective test, and the court needed to determine "how subsection C [addressing the objective standard] is to be applied. Specifically, how are we to determine the relevant industry and how much of a departure from that industry's norm will subsection C allow?"[12] In addressing the second point (the departure from the industry norm), the Fourth Circuit adopted the Third Circuit's sliding-scale analysis upon the "preinsolvency course of dealing between the parties, not the prepreference course of dealing between the parties."

Despite that *Advo-System* was decided prior to the enactment of BAPCPA, the court applied the "preinsolvency course of dealing" precedent of *Advo-System* by adopting the liquidity event, which the court described as "the onset of the Debtor's financial distress," as the baseline from which to determine the ordinary course of business of the parties.[13] While the court acknowledged that the specific time at which the debtor became legally insolvent had not been established,[14] it found "the shift in payment practices that occurred as a result of the liquidity crisis to be sufficiently analogous to deem the Liquidity Event as marking the cessation of ordinary business practices. Regardless of whether the Debtor was in fact insolvent or simply changing its payment practices in reaction to its slide towards insolvency, the court found that the business practices of the Debtor were no longer ordinary after the Liquidity Event."[15]

This analysis presents three problems. First, in applying *Advo-System* (and the Third Circuit's decision in *In re Molded Acoustical Prods. Inc.*,[16] upon which *Advo-System* relied), the bankruptcy court attempted to graft the analysis of a now-inapplicable (pre-BAPCPA) law to its analysis of another case entirely by adopting the term "pre-insolvency" from the Fourth Circuit's analysis of a different subsection.[17]

Second, the Fourth Circuit never provided any analysis as to why it was important to focus on the "preinsolvency" relationship between the debtor and the creditor (as opposed to the pre-preference relationship). Had the *Circuit City* court looked beyond *Advo-System*'s adoption of the sliding scale adopted by *Molded Acoustical*, it would have found that the Third Circuit used the phrase "preference period" and "insolvency period" interchangeably.[18] The Third Circuit's emphasis on the "preinsolvency" relationship was intended to serve as a means of evaluating of the pre-preference relationship between the parties.

Which gets us to the third significant problem: Section 547(f) of the Bankruptcy Code provides a presumption that the debtor is insolvent for purposes of § 547 "on and during the 90 days immediately preceding the date of the filing of the petition."[19] Unfortunately, by considering only those payments made prior to when the debtor appears to have first had financial issues, rather than when the debtor was actually insolvent (or at least when the debtor is statutorily entitled to a presumption of insolvency), the court significantly—and admittedly without any factual basis—widened the presumption of the debtors' insolvency by equating the debtor's poor cash flow with insolvency.

Finally, after deciding the relevant period for analysis of the parties' payment history, the court was required to compare the applicable historical data to the transfers made during the preference period. In so doing, the court found that even if the one invoice that the defendant conceded was outside the ordinary course of business was excluded from the analysis, the three remaining transfers made during the preference period were made 12-18 days later than payments had been made prior to the liquidity event. This increase of between 12-18 days, the court found, was sufficient to render those payments outside the ordinary course of business. In so holding, the court evaluated a decision relied on by the defendant, *Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.)*,[20] wherein the bankruptcy court found that preferential payments made an average 13 days later than the pre-preference average were made in the ordinary course of business. The *Circuit City* court distinguished the facts of *Huffman* to the instant case based on the very narrow range of the payments made by the debtor to the defendant prior to the liquidity event.[21] Accordingly, the court found that the 12- to 18-day difference was "significant and precludes the application of section 547(c)(2)."[22]

Ultimately, it is entirely reasonable that a court could conclude that transfers made 12-18 days after the pre-preference average may be outside of the ordinary course

9 *Id.* Prior to the enactment of the BAPCPA, the ordinary-course-of-business defense required that a defendant prove (1) that the transfers were payments of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, (2) such transfers were made in the ordinary course of business or financial affairs of the debtor and the transferee; and (3) such transfers were made according to ordinary business terms. Section 547(c)(2) now provides that the defendant prove that the transfers were in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and either (1) such transfers were made in the ordinary course of business or financial affairs of the debtor and the transferee; or (2) made according to ordinary business terms.

10 In *Advo-System*, the court adopted the sliding scale analysis of *Molded Acoustical*, 18 F.3d 217, 223-26 (3d Cir. 1994), which provided that the extent to which a preference payment's credit terms can stray from the industry norm yet still satisfy the objective test of the ordinary course of business depends on the duration of the debtor-creditor relationship. "[T]he more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain within the safe harbor of § 547(c)(2)." A "sliding-scale window" is thus placed around the industry norm. On one end of the spectrum, "[w]hen the relationship between the parties is of recent origin, or formed only after or shortly before the debtor sailed into financially troubled seas, the credit terms will have to endure a rigorous comparison to credit terms used generally in a relevant industry." In such a case, only those "departures from [the] relevant industry's norms which are not so flagrant as to be 'unusual' remain within [the ordinary course of the industry]." On the other end of the spectrum, "when the parties have had an enduring, steady relationship, one whose terms have not significantly changed during the pre-petition insolvency period, the creditor will be able to depart substantially from the range of terms established under the objective industry standard inquiry and still [be within the ordinary course of the industry]." *Advo-System*, 37 F.3d at 1049 (quoting *Molded Acoustical*, 18 F.3d at 225-26) (internal citations omitted).

11 The "subjective test" refers to whether the transfers were made in the ordinary course of business between the debtor and the transferee, and the "objective test" refers to whether the payments were made according to ordinary business terms in the relevant industry.

12 *Advo-System*, 37 F.3d at 1048.

13 *Id.*

14 *Id.* at n. 9.

15 *Id.*

16 In *Molded Acoustical*, the Third Circuit appeared to have used the phrase "preference period" and "insolvency period" interchangeably, and compared the debtor's pre-preference dealings with its preference period dealings with the creditor, apparently indicating that its emphasis on the "pre-insolvency" relationship meant to serve as an evaluation of the pre-preference relationship between the parties.

17 In *Advo-System*, the Fourth Circuit addressed the narrow issue of whether or the transfers were made in accordance with the industry standard; in *Circuit City*, the bankruptcy court did not focus on the industry standard at all. The problem with applying the sliding scale test to a different subsection is that the *Molded Acoustical* and *Advo-Systems* courts were specifically attempting to recognize a "flexible approach" for analyzing the industry norm. *See Molded Acoustical*, 18 F.3d at 222, and *Advo-Systems*, 18 F.34d at 1049. The subjective prong has nothing to do with the industry norm. Nor is there any evidence that the courts of appeals intended to provide a similarly flexible approach based on the subjective history of transactions between the debtor and the transferee.

18 *See Molded Acoustical*, 18 F.3d at 227.

19 11 U.S.C. § 547(f).

20 182 B.R. 728 (Bankr. W.D. Va. 1995).

21 2012 WL 1981781 at *6, n. 5.

22 *Id.*

of business, particularly where the parties' pre-preference payment history was within a narrow range or where there were other factors at issue, such as the defendant making a demand for payment or changing the terms of payment. Unfortunately, notwithstanding the court's statement that the Fourth Circuit requires that the ordinary-course analysis be "particularly factual," the court ignored payments made more than a year prior to the petition date and instead chose to focus upon only a subset of payments, and in so doing, appears to have extended the presumption of insolvency further than what is set forth in the Bankruptcy Code. Coupled with the apparent lack of any other, aggravating factors, the *Circuit City* decision incorrectly applied the test of whether the transfers were made in the ordinary course of business or financial affairs of the debtor and the transferee. **abi**

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