

THE IMPLICATIONS OF THE BANKRUPTCY REFORM ACT OF 2005 ON THE ORDINARY COURSE OF BUSINESS DEFENSE IN PREFERENCE RECOVERY ACTIONS

by Kyung S. Lee and Jason M. Rudd

When the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, 119 Stat. 23 (the "Bankruptcy Reform Act of 2005"), takes effect on October 17, 2005¹, it will change Title 11 of the United States Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code") in many ways. One notable change affects defenses available to defendants of preference avoidance actions. In basic terms, a preference occurs when a debtor nearing bankruptcy pays certain creditors but not others. Once the debtor files bankruptcy, the bankruptcy estate can sue to recover the preferential payment to provide equal treatment of all creditors.

The Bankruptcy Reform Act of 2005 expands the ability of a preference defendant to protect itself from liability with the ordinary course of business defense. This article examines the ordinary course of business defense under the existing Bankruptcy Code and compares how the Bankruptcy Reform Act of 2005 affects the scope of the ordinary course of business defense.

Preference Recovery Under 11 U.S.C. § 547

Bankruptcy Code section 547 provides a debtor's estate a cause of action to recover payments or transfers a debtor made to creditors within a certain time before the debtor

filed its bankruptcy petition. The goal of preference recovery is to facilitate the equal treatment of all creditors by (i) discouraging an insolvent debtor from "preferring" certain creditors by paying their claim, while not paying other similarly situated creditors, and (ii) discouraging creditors from attempting to improve their position by engaging in extraordinary collection activities that would aggravate the debtor's financial troubles.

For example, a debtor is running out of funds and has stopped paying its vendors. Vendors continue to ship goods, but one vendor threatens to stop all shipments and sue to collect its unpaid invoices. In response, the debtor pays that vendor's overdue invoices, but then files bankruptcy a month later. The paid vendor has collected 100% on its claim against the debtor; however, the remaining vendors are left with unpaid claims against the debtor's estate. Unless the unpaid vendors receive a full recovery in the bankruptcy proceeding, the paid vendor received a preference. Furthermore, the preferential payment rewarded the vendor's aggressive collection tactics, encouraging other vendors to take similar actions with future debtors, precipitating more bankruptcy filings.

To establish a *prima facie* case for a preference action, the plaintiff must show that the payment or transfer was (i) a transfer of the debtor's property, (ii) made to or for the benefit of a

creditor, (iii) made within 90-days before the debtor filed its bankruptcy petition, or within one year of the petition date if the creditor was an insider of the debtor, (iv) paid on an antecedent debt, (v) made while the debtor was insolvent (insolvency is presumed during the 90-days before the petition date), and (vi) enabled the creditor to receive more than it would have received in a Chapter 7 liquidation of the debtor's estate. 11 U.S.C. § 547(b).

Despite the good intentions behind preference litigation, the fear of preference liability can discourage creditors from doing business with financially troubled entities. To encourage creditors to continue to conduct business with, and extend credit to, debtors nearing insolvency, the Bankruptcy Code provides several affirmative defenses to preference defendants. One such defense is the ordinary course of business defense provided by Bankruptcy Code section 547(c)(2).

Continued on page 7



Kyung S. Lee Jason M. Rudd

