Professional Perspective

Bankruptcy Court Discretion in Choosing Subjective OCB Defense Test

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Section 547 of the Bankruptcy Code empowers certain parties to file lawsuits to claw back "preference payments" made by a debtor to a creditor within the 90-day period before a debtor's bankruptcy filing. However, the Bankruptcy Code provides creditors with certain affirmative defenses to overcome or mitigate preference exposure, to encourage creditors to continue doing business with financially distressed customers.

One such affirmative defense is referred to as the subjective prong of the ordinary course of business defense—the "Subjective OCB Defense." Litigants have asked courts to apply several different tests to determine whether a creditor may avail itself to the Subjective OCB Defense, and, not surprisingly, plaintiffs and defendants alike propose the test(s) that is/are most beneficial to them based on the specific facts and circumstances of a case.

This article explores the statutory framework of the Subjective OCB Defense, explains some of the common tests that courts apply, and then examines one case in which the bankruptcy court applied the "Average Lateness" test to analyze the merits of the creditors' defense.

Statutory Framework

Preference Claims

Under § 547(b), a debtor or trustee can "avoid" a transfer if certain prima facie preference elements are satisfied. Essentially, if all elements are satisfied, a transaction can, subject to certain defenses, be cancelled. For transfers avoided under this provision, § 550(a) then empowers the trustee to "recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property," and redistribute the amounts disgorged pro rata pursuant to the absolute priority rule.

The preference provisions were designed to dissuade a debtor and its creditors from engaging in unusual payment practices or collection activities that may result in certain "preferred" creditors being paid in lieu of others that may have received little or nothing before a bankruptcy filing.

To avoid the harsh consequences of the avoidance and recovery of a preferential transfer, § 547(c) also provides creditors with nine defenses to a preference claim. The Subjective OCB Defense, which is codified in § 547(c)(2)(a), is a subpart of one of those defenses, and states, in pertinent part:

> The trustee may not avoid under this section a transfer—
>
> *****
>
> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> *****

Typically, the Subjective OCB Defense focuses initially on the timing of the preference period payments. The goal is to test whether the preference period payments are consistent with the parties' prior practices during a representative historical period. If the timing of payments during the preference period is in line with the parties' typical payment practices during the historical period, a creditor can potentially satisfy the Subjective OCB Defense.

In making the timing comparison, courts employ a wide variety of analyses/tests, with the goal of providing a fair picture of "ordinariness," including:

- The application of high/low ranges, modified ranges removing outliers, and/or ranges based on a standard deviation
- Comparison of averages
- A bucketing test and other analyses

Under all of these tests, the greater the deviation in payment time—i.e., number of days from invoice date to payment date, or number of days early or late if multiple payment terms are utilized during the parties' history—or average days-to-pay or days early/late during the preference period as compared to the historical period, the less likely that a defendant will be able to satisfy the Subjective OCB Defense. Once the historical period is identified, courts will analyze the payments made during that period to determine a range of what is subjectively ordinary and then compare that baseline to the payments made during the preference period.

This analysis, however, does not end with a comparison of payment timing. Analyzing whether a payment is preferential also involves a number of additional considerations, none of which are dispositive. Considerations include, but are not limited to:

- The length of time the parties were engaged in business
- Whether the payment amounts or number of invoices paid during the preference period were more or less than during the historical period
- Whether the payments were tendered differently during the two periods
- Whether there was any unusual action by the debtor or creditor to collect on or pay the debt during the preference period
- Whether the creditor did anything else to gain an advantage in light of the debtor's deteriorating financial condition leading up to the bankruptcy filing

Average Lateness & Total Range Tests

One of the analyses courts apply is the "Average Lateness" test, which compares the average timing of payment of invoices during the historical period and the preference period. Under the Average Lateness test, if the difference in averages is not material, all of the alleged preferential transfers will be deemed protected by the Subjective OCB Defense.

Another analysis courts apply is the "Total Range" test. Here, the lowest number of days from invoice date to payment date and the highest number of days from invoice date to payment date are treated as "book ends," and treated as the historical period range. Courts then apply that high/low range to the payments made during the preference period, and, if the preference period payments fit within the historical period high/low range, they will be considered ordinary.

The Total Range test, in most cases, is clearly an attractive option for defendants, as it has the potential to protect the widest range of payments from avoidance, even those that may arguably be outliers. However, it should be noted that some courts have rejected this test because it "captures outlying payments that skew the analysis of what is ordinary," and thus, may impermissibly expand the appropriate range of ordinary transactions. See *Davis v. All Points Packaging & Distribution, Inc* (*In re Quebecor World (USA), Inc.*), 491 B.R. 363, 387 (Bankr. S.D.N.Y. 2013).

Bucketing Test

Other courts rely upon the "Bucketing" test, in which the court groups the payments made during the historical period into "buckets" by age, then applies the same sized buckets to the preference period payments. Those preference period payments that fall within or overlap with those same buckets will be considered ordinary.

Ryniker v. P. Kaufmann, Inc.

Plaintiff-appellant Bryan Ryniker in his capacity as the litigation administrator of the post-confirmation estates of Décor Holdings, Inc., et al. filed complaints in the US Bankruptcy Court for the Eastern District of New York against a slew of defendant-creditors for various sums.

In August 2021, three sets of defendants filed motions for summary judgment seeking dismissal of all the claims, arguing, among other things that, each of them was entitled to a complete Subjective OCB Defense with respect to payments made during the preference period. Plaintiff subsequently filed a cross-motion for summary judgment.

In February 2022, the bankruptcy court dismissed the claims because all of the payments received by the defendants during the preference period were shielded by the Subjective OCB Defense. Although plaintiff had urged the bankruptcy court to employ the Total Range test when analyzing the Subjective OCB Defense, arguing that it "provides a more complete picture of the relationship between each of the Defendants and Debtors," the bankruptcy court determined that the test improperly relied upon certain outlier payments that were not indicative of the parties' subjective ordinary course of business.

Therefore, the bankruptcy court concluded that relying on the Total Range test, inclusive of such outliers, would result in too broad of a historical range. See *Ryniker v. P. Kaufmann, Inc. (In re Decor Holdings, Inc.)*, No. Chapter 11, 2022 BL 39210, (Bankr. E.D.N.Y. Feb. 03, 2022).

Application of Average Lateness Test

Instead of the Total Range test, the bankruptcy court applied the Average Lateness test to determine whether the defendants could avail themselves of the Subjective OCB Defense. The bankruptcy court compared the average days early/late during the preference period, from Nov. 14, 2018, to Feb. 12, 2019, to the average days early/late during the relevant historical period.

The bankruptcy court observed that:

- Defendant P. Kaufmann, Inc. had an average of 40.5 days late during the historical period compared to 36.7 days late in the preference period
- Defendants Swavelle / Mill Creek Fabrics, Inc. and Rosenthal & Rosenthal, Inc. had an average of 39.3 days late during the historical period compared to 46.2 days late in the preference period
- Defendants Bravo Fabrics and Rosenthal & Rosenthal, Inc. had an average 47.5 days late during the historical period compared to 45.2 days late in the preference period

Findings

The bankruptcy court found that there was not a material enough difference to hold that the preference payments were not shielded by the Subjective OCB Defense where the historical period and preference period averages differed by at most just seven days. The bankruptcy court specifically noted that there was no unusual collection activity during the preference period, the manner of payments remained consistent, the debtors never informed the creditors of any financial troubles, and the defendants did not exert any unusual payment pressure on the debtors.

Based on this, the bankruptcy court concluded that all of the alleged preference payments were shielded by the Subjective OCB Defense. Given these conclusions, the bankruptcy court granted the defendants' respective summary judgment motions and dismissed the claims.

Decision

The plaintiff appealed the bankruptcy court's decision to the US District Court for the Eastern District of New York. The plaintiff argued that the bankruptcy court erred by holding that the defendants' satisfaction of the Average Lateness test alone was sufficient to establish the Subjective OCB Defense and failed to address plaintiff's substantive legal arguments that the Average Lateness test was inapplicable because certain outlier transfers skewed the analysis.

Notwithstanding these arguments, the district court affirmed the bankruptcy court's decision, and in doing so, emphasized the bankruptcy court's authority to employ the Subjective OCB Defense test of its choice, observing that the "Bankruptcy Court has the sole discretion to determine which test or methodology to apply." Like the bankruptcy court, the district court held that the payments satisfied the Subjective OCB Defense because they "were within the acceptable range." Indeed, the district court found that the bankruptcy court properly applied the Average Lateness test and concluded that the alleged "outliers" were "completely in character based on the parties' prior payment history."

The district court also ruled that the bankruptcy court went above and beyond what was necessary by also applying the Bucketing test. The district court stated, "while the Bankruptcy Court was under no obligation to consider a second test, this Court also finds that under an alternative Bucketing Test, the payments made during the Preference Period fall within an acceptable range and accordingly, were made in the [subjective] ordinary course of business." See *Ryniker v. Bravo Fabrics*, 643 B.R. 379 (E.D.N.Y. 2022).

Conclusion

One of the key takeaways from the district court's decision is that a bankruptcy court has substantial, if not complete discretion to choose which Subjective OCB Defense test(s) to apply to the specific facts and circumstances of a case. While parties may assert a variety of tests to either support or dispel the applicability of the Subjective OCB Defense, they are likely to be bound by the test(s) chosen by the bankruptcy court, even on appeal.

This means that, in practice, a preference defendant only has one bite at the apple when choosing the most favorable test(s) to establish the Subjective OCB Defense—i.e., during its arguments before the bankruptcy court. Accordingly, preference defendants must review, sift through, manipulate, and analyze the relevant historical and preference period data to identify the most favorable test(s) to rely upon, and then must assert each of its compelling arguments at the bankruptcy court level. As the *Décor* holding has demonstrated, the test(s) chosen by the bankruptcy court will more than likely be the test any appellate court will apply, as well.