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Payment Pressure Can Be Hazardous to Your Ordinary Course of Business Preference Defense

Trade creditors should take notice when any United States Court of Appeals rules on the applicability of a preference defense. Well, the United States Court of Appeals for the Third Circuit is no exception, particularly because the United States Bankruptcy Court in Delaware, where many large commercial Chapter 11 cases are filed, is in the Third Circuit.

The Third Circuit's recent ruling, in *Burtch v. Prudential Real Estate & Relocation Services, Inc., et al.*, provides important guidance to trade creditors, seeking to mitigate their preference risk, on the applicability of the ordinary course of business ("OCB") and subsequent new value ("SNV") defenses. Bottom line: while a creditor's efforts to collect its past due claim, such as by changing terms, imposing a credit hold, and/or applying other collection pressure, might increase the likelihood of collection, these actions might also have the unintended consequence of frustrating the creditor's ability to prove the OCB defense (and increasing the creditor's preference liability) for payments that might have otherwise been regarded as ordinary course transactions.

The Elements of a Preference Claim and the OCB and SNV Defenses

Pursuant to Bankruptcy Code Section 547(b), a trustee can avoid and recover a transfer as a preference if he or she proves that (i) a debtor transferred its property (frequently by making a payment from its account) to or for the benefit of a creditor; (ii) the transfer was made on account of an antecedent debt, such as an unpaid invoice that the debtor owed to a creditor; (iii) the transfer was made within 90 days of the bankruptcy filing date, in the case of a transfer to a non-insider creditor, and within one year of the filing date for a transfer to an insider; (iv) the transfer was made when the debtor was insolvent based on a balance sheet definition of insolvency—liabilities exceeding assets, that is presumed during the 90-day preference period; and (v) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation.

Once a trustee satisfies all of Section 547(b)'s requirements, the creditor has the burden of proving one or more of the affirmative defenses contained in Bankruptcy Code Section 547(c) to reduce its preference liability. The OCB defense, in Section 547(c)(2), is one



such frequently invoked preference defense. The OCB defense was enacted to encourage creditors to continue doing business with, and extending credit to, their financially distressed customers facing bankruptcy. First, a creditor must prove that an alleged preferential transfer paid a debt incurred in the ordinary course of the debtor's and creditor's business or financial affairs. A trade creditor satisfies this requirement by proving its prior extension of credit to the debtor. The creditor must then prove the transfer was made either (a) in the ordinary course of the debtor's and creditor's business or financial affairs (the "subjective" prong), or (b) according to ordinary business terms (the "objective" prong).

The SNV defense, contained in Section 547(c)(4) of the Bankruptcy Code, provides:

The trustee [or debtor-in-possession] may not avoid under [Section 547(b)] a transfer [as a preference]—

... to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

A creditor satisfies the SNV defense by proving that it had sold and delivered goods and/or provided services to the debtor on credit terms *after* an alleged preference payment. The SNV defense is also supposed to encour-

age creditors to continue extending credit to their financially distressed customers. The rationale for this defense is that a debtor's unsecured creditors can be no worse off by the debtor's payments during the preference period if the creditor had subsequently provided an equal amount of new value to the debtor in the form of goods sold and delivered and/or services provided on credit terms.

Facts

Prudential Real Estate and Relocation Services, Inc. and Prudential Relocation, Inc. (collectively "Prudential") provided relocation/moving services for its client's employees. On May 1, 2006, Prudential and AE Liquidation, Inc. f/k/a Eclipse Aviation Corporation ("Eclipse") entered into a Relocation Services Agreement (the "Agreement"). According to the Agreement, Prudential's invoices were payable within 30 days. From execution of the Agreement, through the summer of 2007, Eclipse had paid Prudential within the required 30-day terms. However, Eclipse's account fell into arrears starting in the summer of 2007, and as of November 2007, Eclipse owed Prudential \$1.7 million that was outstanding more than 60 days.

Prudential responded by implementing "special measures" to bring Eclipse's account current. Prudential unilaterally imposed a payment plan that required Eclipse to make weekly payments of \$200,000 each and a lump sum payment of \$900,000 due by December 2007 (the "First Payment Plan"). Prudential also placed Eclipse's account on "billing review," which entailed additional scrutiny of all new orders and continuous monitoring of the account. Beginning on November 26, 2007, and continuing through January 2008, Eclipse timely made the weekly payments of \$200,000. Eclipse also paid the balance of approximately \$900,000 owing to Prudential on January 4, 2008. As a result of these payments, Prudential removed Eclipse's account from "billing review" in late January 2008.

In March 2008, Eclipse again fell behind in payment of Prudential's invoices. And, as of August 28, 2008, Eclipse's balance owing to Prudential had increased to \$800,000, of which approximately \$600,000 was overdue. Also, around that time, Prudential learned that Eclipse had terminated 650 employees and instructed those employees to submit their unpaid relocation expenses to Prudential for payment. Likewise, Prudential learned that Eclipse needed to conserve cash for the next two to three months. In response, Prudential put Eclipse back on billing review and required Eclipse to enter into a second payment plan that included weekly payments of \$50,000 each and a subsequent lump sum payment for the remaining balance owing by Eclipse to Prudential (the "Second Payment Plan").

The Preference Payments

Eclipse filed its bankruptcy case on November 25, 2008 (the "Petition Date"). During the 90-day period prior to the Petition Date (the "Preference Period"), Eclipse made 12 payments, totaling \$781,702.61 to Prudential (the "Preference

Payments"). The Preference Payments included: (a) five \$50,000 payments in September 2008 made under the Second Payment Plan, and (b) seven \$75,000 payments in October and November 2008 made under a third payment plan (the "Third Payment Plan").

The increase in weekly payments under the Third Payment Plan stemmed from a September 24, 2008, demand by Prudential to Eclipse, requiring an increase in Eclipse's weekly payments from \$50,000 to \$75,000. When Eclipse failed to respond to Prudential's initial demand, Prudential sent an email to Eclipse on September 28, 2008, threatening to "re-evaluate our options, up to and including termination" of its relationship with Eclipse. That same day, Eclipse agreed to the Third Payment Plan. Prudential also began sending a weekly billing summary to Eclipse and required Eclipse to fully pay the amounts contained in the summary. Prudential only issued a complete invoice to Eclipse after Eclipse had fully paid the charges in the summary.

The Preference Lawsuit and Prudential's and Eclipse's Arguments

The Chapter 7 trustee for Eclipse's bankruptcy estate sued Prudential for the recovery of the Preference Payments. Prudential asserted the subjective part of the OCB defense and the SNV defense.

Prudential argued for the applicability of the subjective prong of the OCB defense because Prudential's collection efforts during the Preference Period, culminating in the Second Payment Plan and Third Payment Plan, were consistent with the parties' course of dealing, including the First Payment Plan, which Eclipse had agreed to a year before the Petition Date. Prudential also sought to de-emphasize its collection efforts during the Preference Period and show consistency between the Preference Payments and payments prior to the Preference Period because the Preference Payments were made (a) only 19 days faster than the payments before the Preference Period, and (b) within the high/low range of payments (from invoice date to payment date) prior to the Preference Period. Likewise, Prudential argued that, when invoking the OCB defense, it did not need to prove "absolute uniformity" in the frequency of payments made prior to and during the Preference Period.

Eclipse disputed the applicability of the subjective OCB defense. Eclipse sought to limit the pre-Preference Period history the court should consider to only Eclipse's payments to Prudential when Eclipse was "financially healthy" before the mid-summer of 2007. During that "healthy" period, Eclipse was paying Prudential in accordance with its 30-day payment terms, there was no payment plan, no billing review and no other unusual collection efforts by Prudential. This contrasted with Prudential's "escalating collection tactics," particularly during the Preference Period, that included Prudential's imposition of the Second Payment Plan and, then following an ultimatum by Prudential, Prudential's imposition of the Third Payment Plan.

The Lower Court Decisions

The Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”) held that the Preference Payments were not protected by the subjective prong of the OCB defense. The Bankruptcy Court also initially gave Prudential a new value credit of \$128,379.40 based on services Prudential had provided to Eclipse both prior to and after the Petition Date.

The Delaware District Court affirmed the Bankruptcy Court’s decision on the OCB defense, but remanded the SNV issue to the Bankruptcy Court to address the amount of Prudential’s subsequent new value provided to Eclipse. On remand, the Bankruptcy Court reduced Prudential’s subsequent new value credit to \$56,571.37 based only on services Prudential had provided to Eclipse prior to the Petition Date.

The District Court affirmed the Bankruptcy Court’s ruling on appeal and Prudential filed an appeal with the Third Circuit.

The Third Circuit’s Decision

The Third Circuit affirmed the Bankruptcy Court’s ruling on the OCB defense and held that none of the Preference Payments were shielded from liability due to Prudential’s unusual collection efforts.

The court relied on Prudential’s material changes to the credit terms provided to Eclipse from the 30-day terms contained in the Agreement, to faster weekly and lump sum payments of the balance owing required by the Second Payment Plan and Third Payment Plan. Significantly, Prudential imposed these more onerous terms only after Prudential had learned about

Plan and the First Payment Plan implemented a year before the bankruptcy. The court noted that the timing of the Preference Payments, 19 days faster than payments prior to the Preference Period and within the high/low range of days to pay from invoice date, was just one of the factors the Bankruptcy Court considered in determining the applicability of the OCB defense. The Third Circuit again focused on Prudential’s email ultimatum to Eclipse, in September 2008, threatening to terminate the parties’ relationship if Eclipse did not agree to the Third Payment Plan. Prudential had never previously sent this type of coercive email to Eclipse prior to the Preference Period, even in connection with the First Payment Plan. Likewise, the Third Circuit noted that neither the First Payment Plan nor the Second Payment Plan were simple renegotiations of the Agreement, but instead amounted to “unilateral pressure [tactics] by Prudential on Eclipse to assure future payment.”

The Third Circuit also affirmed the Bankruptcy Court’s SNV calculation, which limited Prudential’s new value credit to services provided prior to the Petition Date. The Third Circuit concluded that the Bankruptcy Court, on remand, had considered sufficient information when calculating the SNV credit, as there was persuasive and uncontested testimony from a Prudential employee and a detailed chart illustrating each invoice included in the SNV calculation.

Conclusion

The Third Circuit’s decision highlights certain well-established principles a trade creditor should consider when managing both collection and preference risks prior to its customer’s bankruptcy filing. First, a creditor that engages in unusual collection activity or pressure during the preference period risks the loss of the OCB defense. Any similarity in timing of a debtor’s payments to the creditor prior to and during the preference period may not change this outcome. Second, a creditor’s SNV credit only includes goods or services provided through, but not after, the bankruptcy filing date. ■

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Eclipse’s deteriorating financial condition during the Preference Period and pressured Eclipse to agree to these terms.

The Third Circuit, agreeing with the Bankruptcy Court, noted that “Prudential’s threatening Eclipse into making increased payments to bring the [accounts receivable] current during the Preference Period was not in the ordinary course of business” as “[t]his type of ultimatum never occurred in the pre-Preference Period (even in connection with the First Payment Plan).” The Third Circuit also relied upon internal Prudential employee emails recognizing concerns about Eclipse’s liquidity and financial instability, worries about Eclipse’s ability to pay its indebtedness to Prudential, and Prudential’s threat to end its relationship with Eclipse during the Preference Period.

The Third Circuit rejected Prudential’s argument that the OCB defense applied to reduce Prudential’s preference liability because of the consistency between the Second Payment