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COVID's Impact on the Ordinary-Course-of-Business Defense

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In the last year, the COVID-19 pandemic has caused millions of deaths and induced a seismic shift in nearly all aspects of how people live and work. Its effects have also significantly affected corporations, including how business is conducted. The phrase "new normal" has entered common parlance, and what was once "ordinary" no longer is.

This article explores the post-pandemic viability of the "ordinary-course-of-business" defense to preference actions, where the current standards for applying the defense fail to consider a pandemic that caused the world to "effectively grind to a halt."[1] The article then suggests adjustments to the courts' current approach to evaluating that defense to account for the drastic changes wrought by COVID-19.

The Ordinary-Course Defense

The ordinary-course defense prevents a challenged transfer from being avoided as a preference where the transfer satisfies, among other things, either of the following two conditions: "(A) [the transfer was] made in the ordinary course of business or financial affairs of the debtor and the transferee *or* (B) [the transfer was] made according to ordinary business terms."[2] The first condition requires a subjective review (herein, the "subjective test"): compared to the historical transactions between the creditor and *this* debtor, was the challenged transfer "ordinary"? The second condition requires an objective review (herein, the "objective test"): compared to transactions between commercial parties in the same industry, was the challenged transfer "ordinary"? Satisfying either two alternative conditions provides a complete defense to a preference claim.

The Bankruptcy Code does not define "ordinary course of business," and the legislative history similarly fails to provide meaningful interpretive guidance. The legislative history discussing § 547(c)(2) of the Code simply states that the "purpose of this exception is to leave undisturbed normal financing relations, because [permitting the continuation of normal relations] does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy."[3] With no substantive guidance and the myriad ways in which parties do business, bankruptcy courts evaluating a creditor's assertion of the ordinary-course defense can only embark on a "peculiarly factual analysis."[4]

The Subjective Test: Ordinary as Between the Debtor and Creditor

Applying the subjective test, a court compares the challenged transfer to the payment history between the debtor and creditor prior to the "preference period," the 90-day period preceding the bankruptcy filing. The framing of that "baseline of dealing" between the parties is subject to considerable judicial discretion and, therefore, considerable uncertainty. It has been noted that the relevant period to be used as a baseline must be fixed, at least in part, during a time in which debtors' day-to-day operations were "ordinary" in the layman's sense of the word.[5]

Many courts have ruled that the baseline period should be limited to a period of time in which the debtor was financially healthy.[6] One court stated:

1 *In re Pier 1 Imports Inc.*, 615 B.R. 196, 198 (Bankr. E.D. Va. 2020).
2 11 U.S.C. § 547(c)(2) (emphasis added).
3 S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874.
4 *Jones v. United Sav. & Loan Ass'n (In re U.S.A. Inns of Eureka Springs, Ark. Inc.)*, 9 F.3d 680, 683 (8th Cir. 1993).
5 5 *Collier on Bankruptcy*, ¶ 547.04[2][a][ii] (16th ed. 2020).

[T]he historical baseline should be based on a time frame when the debtor was financially healthy, and should reflect payment practices that the companies established before the onset of any financial distress associated with the debtor's impending bankruptcy [and] should be grounded in the [company's] payment history rather than dictated by a fixed or arbitrary cutoff date.[7]

Where a debtor's payment practices abruptly change after a material deterioration in its finances such that a "new paradigm" of payment practices arises, payments after the financial deterioration should be excluded from the baseline period.[8] However, this stringent standard, while prevalent, has not been universally adopted. At least one court has held that the baseline period "should extend back into the time before the debtor became financially distressed or at least before the debtor was subject to a deep structural change."[9] Under this standard, a period of financial distress may be included within the baseline considered by the court.

The more stringent standard, requiring the exclusion of any period of economic distress, fails to account for the worldwide cataclysmic changes in businesses caused by a pandemic. Adhering to that pre-COVID standard in a post-COVID world might render the subjective test a dead letter: Comparing post-pandemic transfers to solely pre-pandemic payment histories seems almost to doom the defense to failure. Continuing to use the prevailing standard for defining the "baseline period" would ignore the reality of the current business and economic landscape, which may have included significant changes in payment terms to accommodate the debtor during the pandemic.

Objective Test: Ordinary in the Industry

Contrasted with the subjective test, the objective test appears to better account for the present-day economic issues caused by COVID-19. Thus, the objective test more closely adheres to the purpose of the defense: protecting "ordinary" transfers. Under this test, a creditor must establish that the payment at issue was not so flagrant or idiosyncratic as to be unusual in light of an industry's norms.[10] Under this approach, courts are directed to consider the broad range of "terms employed by similarly situated debtors and creditors facing the same or similar problems."[11] Moreover, "[i]f the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry."[12] Thus, it is not required that a transaction occurred often or regularly to fall within the objective test.[13] Unlike the majority approach for the subjective test, nonpreference period transfers made during times of distress are not automatically excluded from the baseline of "ordinary."

Commentators have observed that "consideration of industry environment contemporaneous to the transfers" can be extremely helpful in establishing "ordinary business terms" for purposes of the objective test.[14] While not explicitly stating so, courts appear to suggest that the industry standards should be determined as those in effect during the preference period.[15] If this is true, then this test will take into account the prevailing economic conditions during the pandemic, something that the current subjective test fails to do.

Rethinking the Standards for "Ordinary"

For the subjective test to be viable in the post-pandemic era, courts should reconsider requiring data only from the time that debtors were financially healthy. Given the wide discretion afforded the courts in interpreting "ordinary," the "baseline of dealing" should account for the changed global economic conditions by including (if not beginning) payments made during and after March 2020 — or some other date that serves as a proxy for the onset of the COVID-19 pandemic in the U.S. At the very least, greater weight should be given to payment data falling within this time period. Using the payment history between the parties after March 2020 is especially appropriate when creditors were changing credit terms to accommodate the new financial realities, including distress, experienced by all parties because of the pandemic.

Courts need not ignore precedent to make this change. The case law acknowledges that interpreting and applying the ordinary-course-of-business defense is a "peculiarly factual analysis." Therefore, courts are already empowered to acknowledge reality, including the fact of COVID-19's effects on business transactions. Neither the text of § 547(c)(2), nor the policy set forth in the legislative history of this section, establishes a "financial health" requirement for the subjective test. Rather, § 547 was enacted to encourage creditors to avoid actions that would hasten a debtor's slide into bankruptcy.

In the context of a widespread economic crisis, looking solely at historical data from the period during which the debtor was financially healthy discourages creditors from loosening payment terms to meet a debtor's limited cash flows. As such, the current approach undermines rather than furthers the policy underlying preference law.

By failing to make this necessary change when applying the subjective test, courts would be choosing to negate an entire defense provided by statute and leaving creditors only with the objective test to defend against preference claims. For this reason, courts should give effect to the entire statute and consider all economic and industry changes caused by the pandemic.

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6 *Unsecured Creds. Comm. v. Jason's Foods Inc.*, 826 F.3d 388, 394 (7th Cir. 2016); *Cox v. Momar Inc. (In re Affiliated Foods Sw. Inc.)*, 750 F.3d 714, 720 (8th Cir. 2014); *Advo-Sys. Inc. v. Maxway Corp.*, 37 F.3d 1044, 1049 (4th Cir. 1994) (focusing on pre-insolvency relationship between debtor and creditor); *Stanziale v. Superior Tech. Res. Inc. (In re Powerwave Techs. Inc.)*, 2017 WL 1373252, at *4 (Bankr. D. Del. April 13, 2017).

7 *Yoo v. Zeta Interactive (In re Blue Global LLC)*, 591 B.R. 433, 446 (Bankr. C.D. Cal. 2018) (internal quotation marks and citations omitted). *See also Dooley v. Luxfer MEL Techs. (In re Fansteel Foundry Corp.)*, 617 B.R. 322, 325 (B.A.P. 8th Cir. 2020).

8 *Yoo v. Zeta Interactive (In re Blue Global LLC)*, 591 B.R. 433, 446 (Bankr. C.D. Cal. 2018).

9 *Iannacone v. Klement Sausage Co. (In re Hancock-Nelson Mercantile Co.)*, 122 B.R. 1006, 1013 (Bankr. D. Minn. 1991).

10 *Gania Credit Corp. v. Anderson (In re Jan Weilert RV Inc.)*, 315 F.3d 1192, 1197 (9th Cir. 2003); *Advo-Sys. Inc. v. Maxway Corp.*, 37 F.3d 1044, 1048-50 (4th Cir. 1994) (focusing on prevailing norms in creditor's industry); *Fiber Lite Corp. v. Molded Acoustical Prods. Inc. (In re Molded Acoustical Prods. Inc.)*, 18 F.3d 217, 224 (3d Cir. 1994); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

11 *In re Jan Weilert RV Inc.*, 315 F.3d at 1197; *see also Lawson v. Ford Motor Co. (In re Roblin Indus. Inc.)*, 78 F.3d 30, 39 & 42 (2d Cir. 1996); *Jones v. United Sav. & Loan Ass'n (In re U.S.A. Inns of Eureka Springs, Ark. Inc.)*, 9 F.3d 680, 685 (8th Cir. 1993).

12 *In re Jan Weilert RV Inc.*, 315 F.3d at 1197; *In re Roblin Indus. Inc.*, 78 F.3d at 42.

13 *In re Magic Circle Energy Corp.*, 64 B.R. 269, 274-75 (Bankr. W.D. Okla. 1986).

14 *See* Neil Steinkamp, *Understanding Ordinary: A Primer on Financial and Economic Considerations for the Ordinary Course Defenses to Bankruptcy Preference Actions, 2nd Ed.*, at 94 (ABI 2016), available for purchase at store.abi.org.

15 *Cf., In re U.S.A. Inns of Eureka Springs, Ark. Inc.*, 9 F.3d at 683 (requires determination of whether payments are ordinary in relation to standards prevailing in relevant industry); *In re Blue Global LLC*, 591 B.R. at 416 (determination of "broad range" of terms "during the relevant period").

Additional Considerations

Despite having an approach more suitable than the subjective test in recognizing the economic realities of a changed world, the objective test can still be improved to comport with these changed realities. Courts should consider loosening the evidentiary burden associated with establishing industry norms.

Some courts have been reluctant to consider evidence of industry standards in the absence of expert testimony.[16] But in the continued unstable environment of the current pandemic world and the uncertain immediate future (*e.g.*, as-yet-unknown vaccine availability and efficacy, undetermined government economic assistance, etc.), the reliability (and perhaps availability) of any expert witness testimony regarding industry standards during this period is questionable. Maintaining the requirement of expert witnesses in this economic climate will only further burden creditors and ensure that, in many situations, the litigation costs to prove a valid defense will continue to cause preference cases to be resolved based on costs rather than merits.

This is not to say that the ordinary-course-of-business defense has been eviscerated in the wake of COVID-19, nor does it mean that all such creditors need to start reserving funds to address an impending tidal wave of preference litigation. Certain recent legislative changes and typical chapter 11 plan-confirmation negotiations temper such a harsh outcome.

The Consolidated Appropriation Act of 2021 (CAA),[17] which became effective on Dec. 27, 2020, protects certain "covered payments" made to commercial landlords and certain trade vendors who provided assistance to their tenants and customers in response to the COVID-19 pandemic. Section 1001(g) of the CAA prevents plaintiffs from avoiding payments that resulted from an agreement to defer payments as preferential transfers.[18] However, the CAA does not cover leases of personal property, leases of residential real estate, or commercial relationships in which sales of goods or provisions of service are documented by nonexecutory contracts (*e.g.*, purchase orders not subject to a master agreement). Thus, the CAA protects many, but not all, of the post-pandemic payments that may be subject to avoidance as preference.

Moreover, unsecured creditors' committees have been increasingly successful in negotiating preference waivers for unsecured creditors in reorganization plans. This trend mitigates the potential preference risk for trade creditors and landlords.[19] Because unsecured creditors will not always be able to count on such waivers, they will need to be prepared to prove that the challenged transfers fall within the protection of the ordinary-course-of-business defense.

Conclusion

The fact that we are living in extraordinary times should not be at the expense of the rights provided creditors under the bankruptcy laws, particularly when debtors will more likely be seeking the protections granted them under the same law. Courts should re-evaluate the standards used to apply the ordinary-course defense to recognize the reality of these extraordinary times. **abi**

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16 *See Stanziale v. Southern Steel & Supply LLC (In re Conex Holdings LLC)*, 518 B.R. 269, 287 (Bankr. D. Del. 2014); *Finley v. Mr. T's Apparel Inc. (In re Washington Mfg. Co.)*, 144 B.R. 376, 380 (Bankr. M.D. Tenn. 1992).

17 *See* H.R. 133 (116th).

18 To qualify as a "covered payment" that is exempt from avoidance, (1) the debtor and landlord/supplier must be parties to an existing nonresidential lease or executory contract for goods or services; (2) they must have amended the lease or contract after March 13, 2020; and (3) the amendment must have deferred or postponed payments otherwise due under the lease or contract without penalty or interest.

19 *See, e.g.*, Am. Jt. Chapter 11 Plan (Technical Modifications of Mahwah Bergen Retail Grp. Inc. (f/k/a Ascena Retail Grp. Inc.) and its Debtor Affiliates [Docket No. 1758], Art. IV.C. at 22 & Art. IV.C. at 33, Case No. 20-33113 (Bankr. E.D. Va.); Debtors' Fifth Am. Jt. Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code [Docket No. 1210], Art. IV.R. at pg. 36, *In re Tailored Brands Inc., et al.*, Case No. 20-33900 (Bankr. S.D. Tex.); Order Confirming the Fifth Am. Jt. Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code [Docket No. 1221], at 19, *In re Tailored Brands Inc., et al.*, Case No. 20-33900 (Bankr. S.D. Tex.); Am. Jt. Chapter 11 Plan of Pier 1 Imports Inc. and Its Debtor Affiliates [Docket No. 789], Article X.D. at 53, Case No. 20-30805 (Bankr. E.D. Va.); Order Confirming the Am. Jt. Chapter 11 Plan of Pier 1 Imports Inc. and Its Debtor Affiliates [Docket No. 967], at 38.