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Seventh Circuit Broadens Ordinary Course of Business Defense to Protect Payments from Preference Recovery

by Irve J. Goldman
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In *Unsecured Creditors Committee of Sparrer Sausage Company, Inc. (In Jason's Food, Inc.)*, 2016 WL 3213096 (7th Cir. June 10, 2016), the Seventh Circuit Court of Appeals rejected a Bankruptcy Court's narrow application of the test for determining whether preference payments may be protected from recovery as having been made in the ordinary course of business between the debtor and creditor, giving creditors a more favorable outlook for protecting such payments in bankruptcy cases in the future. Generally, a preference is a payment made by a debtor within 90 days of its bankruptcy filing on account of an existing debt. One of the defenses to a preference, known as the ordinary course of business defense, protects such payments from recovery if the creditor can establish that the payments were "made in the ordinary course of business or financial affairs of the debtor and the transferee." 11 U.S.C. §547(c)(2)(A).

In determining whether a payment is in the ordinary course of business, courts generally compare the payment history of the parties in the period prior to the beginning of the preference period, going back to a period when the debtor was free from financial distress (the baseline or historical period), to the preference-period payments. Courts have developed two different methods for making this comparison. One method, known as the total-range method, looks to the minimum and maximum invoice ages (invoice issuance date to payment date) during the historical period to define a protected range of payments. The other, known as the average-lateness method, uses the average invoice age during the historical period to determine whether a payment is ordinary.

The Bankruptcy Court in *Jason's Foods* used the average-lateness method, which was approved by the Seventh Circuit. *Id.* at *4. It was the application of that method, however, that the Seventh Circuit found troubling. Specifically, as recounted by the Seventh Circuit, the Bankruptcy Court first observed that the average invoice age increased from 22 days during the historical period to 27 days during the preference period, and then expanded the historical period average by six days on either side, i.e., 16 - 28 days, to determine what payments were ordinary. If a preference-period payment fell outside that range, it was not held not to be protected. *Id*. at *5.

The Seventh Circuit found this methodology to be “excessively narrow” and “arbitrary.” *Id*. In drawing this conclusion, the Seventh Circuit criticized the Bankruptcy Court’s application of the so-called “bucketing analysis” applied by one bankruptcy court in the Southern District of New York in *In re Quebecor World (USA), Inc.*, 491 B.R. 379, 388 (Bankr. S.D.N.Y. 2013).

The bucketing analysis used in *Quebecor* grouped historical-period invoices in buckets by age to determine a range of payments in which a substantial majority of such invoices were paid. It did this because the average invoice age in the historical period was much less than the average in the preference period (27.56 days vs. 57.17 days), *Jason’s Foods*, at *5, and apparently was looking to capture a more normalized or representative payment history. *Quebecor* found that to be 11 - 40 days because 88 percent of the invoices in the historical period were paid within that time frame. *Id*. It then added a five-day cushion to the outside range of 40 days and held that all payments made up to 45 days from invoice date were ordinary. *Quebecor*, 491 B.R. at 388.

The Seventh Circuit in *Jason’s Foods*, although approving of the bucketing analysis in *Quebecor*, held that it was improperly applied by the Bankruptcy Court because the “ordinary course” range it came up with, 16 - 28 days, encompassed just 64 percent of the invoices paid during the historical period. *Id*. The Seventh Circuit expanded that range to 14 - 30 days because adding just two days to either side of the Bankruptcy Court’s range would have captured – you guessed it – 88 percent of the invoices paid in the historical period. *Id*. This had the effect of reducing the preference exposure by over $245,000.

The Seventh Circuit’s decision in *Jason’s Foods* endorses the use of the average-lateness method, supplemented by the bucketing analysis applied in *Quebecor*, in determining whether preference-period payments were made in the ordinary course of business between the parties. While it remains to be seen whether 88 percent will now be considered the new benchmark for the bucketing analysis, the decision at least recognizes that it must be applied in a manner that is fair to creditors and takes into account a substantial majority of the invoices paid in the historical period.