

Preference Actions: What Is The Ordinary Course of Business Defense?

Under Section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can seek to recover property, including money, transferred to a creditor by a debtor referred to as a preference action.¹ If they are successful, the creditor would be in the unfortunate position of being forced to turn over the property despite the creditor's interest in the property. Fortunately, the Bankruptcy Code provides several defenses to a preference action, including what is commonly referred to as the ordinary course of business defense.

Recognized in Section 547(c)(2) of the Bankruptcy Code, the ordinary course of business defense protects ordinary or routine transactions between a debtor and creditor, thereby encouraging creditors to engage with distressed companies. Specifically, a trustee may not recover transferred property if such transfer of property (a) served as payment for a debt incurred by the debtor in the ordinary course of business or its financial affairs and (b)(i) was made in the ordinary course of business or financial affairs or (b)(ii) was made according to ordinary business terms. The first portion of this defense is not often disputed, as creditors can generally establish that the property transferred was on account of a debt owed by the debtor. The common dispute with this defense concerns the latter portion — whether the transfer was in the ordinary course of business or was made according to ordinary business terms.

Transfers in the Ordinary Course of Business

Whether a transfer *was made in the ordinary course* is a subjective inquiry. The court will evaluate the factual circumstances surrounding the relationship between the debtor and creditor, including, but not limited to, (i) the length of time the parties were engaged in the type of dealing at issue; (ii) whether the amounts of the alleged preferential transfers were larger or smaller than prior payments; (iii) whether the payments were tendered in a manner different from previous payments; (iv) whether there was any unusual action by either the debtor or the creditor to collect or pay the debt; and (v) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition.

¹ See How Can You Protect and Defend Your Business From Preference Actions? [tp_creditors-rights-toolkit_protect-and-defend-your-business.pdf](https://www.troutman.com/tp_creditors-rights-toolkit_protect-and-defend-your-business.pdf) (troutman.com)

Transfers Made According to Ordinary Business Terms

Whether a transfer *was made according to ordinary business terms* is an objective inquiry. A creditor relying on this portion of Section 547(c)(2) must show that the transfer of property comports with common practice in the debtor's industry, the creditor's industry, or some combination of both. Often, an expert is needed to establish industry standards.

Other Things to Remember

- **Burden of Proof.** The burden of proof is on the creditor to show the transfer meets the ordinary course of business defense.
- **Initial Transfers.** Depending on the jurisdiction, the first transaction between a creditor and a debtor may fall within the ordinary course of business defense.
- **Late Payments.** A payment that is made late can be the preferential payment if the timing of the payment is inconsistent with past practices between the parties.
- **Pressure to Obtain Payment.** The mere fact that the creditor asserted some pressure to receive payment does not automatically mean the payment was not made in the ordinary course of business. This requires a careful review of the facts and laws of the jurisdiction.

The ordinary course of business defense may prevent a debtor or trustee from reclaiming property as a preferential payment. A creditor seeking to raise the ordinary course of business defense now or in the future should thoroughly review, track, and maintain sufficient documentation with its business counterparties, and retain competent counsel to determine whether it has a legitimate basis to assert the ordinary course of business defense.

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