

## CREDITOR'S RIGHTS TOOLKIT

# 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.<sup>1</sup> 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

Section 548 of the Bankruptcy Code governs fraudulent “transfers.” What constitutes a “transfer” is not as straightforward as one might think. The stereotypical transaction — a debtor gives cash to a third party — likely constitutes a transfer. However, other conduct may constitute a transfer. For example, under the Bankruptcy Code, a transfer may also mean (i) the creation of a lien, (ii) the retention of title as a security interest, and (iii) the foreclosure of a debtor's equity of redemption.

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<sup>1</sup> See [How Can You Protect and Defend Your Business From Preference Actions?](#)

Furthermore, a transaction may constitute a transfer for purposes of Section 548 of the Bankruptcy Code even if the debtor did not make the transfer — a third party may transfer a debtor's interest in property and trigger a fraudulent transfer action.

## 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.