BANKRUPTCY LAW ALERT
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BY: MICHAEL S. AMATO, ESQ.
BRIANA ENCK, ESQ.

Extraordinary Collection Efforts Result in $3.5 Million Judgment in Preference Action

An Indiana Bankruptcy Court Judge held that timely payments made to a supplier by the debtor were not made in the ordinary course of business, and that the creditor was liable to the estate for $3.5 million. O*fficial Committee of Unsecured Creditors of Gregg Appliances, Inc. v. D & H Distributing Co*., 2022 WL 370279 (S.D. Ind. Jan. 13, 2022).

The debtor ("Debtor"), a 220-store appliance and electronics retailer filed for bankruptcy on March 6, 2017 ("Petition Date"). The supplier ("Supplier") was one of the debtor's primary suppliers of consumer electronics. During the 90 day period prior to the Petition Date ("Preference Period"), the Debtor made 61 transfers to the Supplier in the aggregate amount of $4.7 million ("Transfers"). The Official Committee of Unsecured Creditors ("Committee") sued the Supplier to recover the Transfers as voidable preferential transfers.

On summary judgment, Bankruptcy Judge Jeffrey J. Graham held that the Committee had established each of the elements of a preference action under § 547(b) of the Bankruptcy Code, but disputed facts precluded summary judgment on the Supplier's ordinary course of business defense pursuant to § 547(c)(2)(A), and held a trial to determine whether the Transfers were made in the ordinary course of business.

Section 547(c)(2) provides the trustee may not avoid under this section a transfer—

to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms

The Bankruptcy Court noted that determining whether a disputed transaction is consistent with the course of dealing is an "inherently factual analysis." To prevail on the defense, the defendant must establish a "baseline of dealing" so that the court could compare the transfers made during the Preference Period with the parties' prior course of dealings. Judge Graham determined that the historical period included only the time when the Debtor was "financially healthy," and eliminated 15 months before the Petition Date during which the Debtor was in financial distress to compare with the actions of the Supplier and Debtor during the Preference Period (the "Historical Period").

Judge Graham stated that in determining whether a transaction was subjectively in the ordinary course of business, the Court should consider several non-exclusive factors, including: (1) the length of time the parties were engaged in the transaction at issue; (2) whether the amount or form of tender differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection or payment activity; and (4) whether the creditor took advantage of the debtor's deteriorating financial condition.

After reviewing the evidence, Judge Graham held that the Debtor's payment practices during both the Historical Period and Preference Period remained consistent, which supported the ordinary course of business defense. However, emails from the Supplier to the Debtor immediately before and during the Preference Period reflected a significant shift in collection activity. During this period, emails were sent by the Supplier's Vice President of Retail Sales, rather than members of the Supplier's credit team, and were sent directly to Debtor's Senior Vice President of Consumer Electronics, instead of members of Debtor's accounts payable department.

Judge Graham determined that these communications reflected a growing intolerance for Debtor's payment habits and included repeated threats that the Supplier would withhold products absent payment or confirmation of a payment schedule. While it was not clear that the payments were made in direct response to the emails, there was evidence that the Debtor did prioritize payment to the Supplier during the Preference Period, which did not support the ordinary course of business defense.

The Supplier engaged in the following activities which the Bankruptcy Court held contradicted the Supplier's ordinary course of business defense:

- consistently seeking payments from Debtor in communications that frequently included senior management;
- threatening to withhold shipments unless payments were made; and
- limiting its credit exposure to Debtor by significantly reducing its credit limit with Debtor from $12 million to $1 million during the year preceding the Petition Date while the Debtor's business with the supplier was at an all-time high.

Debtor's own employees valued their relationship with the Supplier, and advocated for payment to the Supplier at a time when Debtor's CFO was actively managing Debtor's liquidity. Supplier's efforts were so successful that the Debtor actually had overpaid the supplier as of the Petition Date.

Judge Graham noted that while the evidence before the Court was "hardly overwhelming one way or another" he held that the Supplier failed to meet its burden to establish the ordinary course of business defense by a preponderance of evidence, and awarded judgment in favor of the Committee in the amount of $3.5 million.

Creditors must take precautions when dealing with companies in financial distress. In *Official Committee of Unsecured Creditors of Gregg Appliance Inc*., the Court noted that § 547 is designed to encourage creditors to continue to do business with struggling companies. However, under such circumstances, it is imperative that creditors do not substantially deviate from established business practices between the parties, so that payments otherwise made in the ordinary course of business are not subject to recovery by the debtor or its estate.

For more information, please contact:

Michael S. Amato, Esq.
516.663.6517
mamato@rmfpc.com

Briana Enck, Esq.
516.663.6683
benck@rmfpc.com