

# Client Alert

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Shumaker, Loop & Kendrick, LLP

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## Preferences - Mining the Ordinary Course of Business Defense

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The 10th U.S. Circuit Court of Appeals issued an important preference decision on August 10, 2015.

### What You Need to Know

Payments to creditors arising from a recent, single business transaction can be protected by the ordinary course of business defense.

### C.W. Mining Company Case

The debtor C.W. Mining Company was failing. In an attempt to survive, it decided to try something new, specifically to increase coal production by converting its mining operations from continuous mining to a long wall system.

To this end, in June, 2007, C.W. Mining entered into a contract with SMC Electrical Products, Inc. to purchase the requisite equipment and installation services for over \$1 million, to be paid in a series of progress payments. One such payment of \$200,000 was made in the 90 day preference period preceding an involuntary filing seven months after entering into the contract. On September 16, 2010, C.W. Mining filed an adversary proceeding against SMC Electrical to recover the \$200,000 as a preferential payment.

SMC Electrical defended, in part, based on the ordinary course of business defense. C.W. Mining countered that, in essence, the ordinary course of business defense cannot apply to payments arising from a single business transaction because there is no "course of business" between the parties.

The Bankruptcy Court ruled in favor of SMC Electrical, C.W. Mining appealed twice, and the 10th Circuit U.S. Court of Appeals agreed with Bankruptcy Court, and with SMC Electrical.

### What Made the Court Rule with the Creditor?

- The 10th Circuit Court carefully examined the wording of the ordinary course of business section in Section 547(c)(2)(A) of the Bankruptcy Code:

The trustee may not avoid 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."

- Debt Incurred. Focusing on the highlighted portion above, the court rejected the interpretation that the statute means incurred in the ordinary course of business *between the debtor and the creditor*. Otherwise, a first time transaction would never be eligible for the ordinary course of business defense.

Instead, the court analyzed whether the debt was incurred in the ordinary course of business of the debtor, and also in the ordinary course of business of the creditor. The court found the contract was “within the normal scope of products and services” provided by the creditor. The court further found that the contract for purchase by the debtor was arm’s length and the undisputed purpose was to assist in mining operations, the debtor’s normal business.

- In applying the ordinary course of business defense in this case, the court noted the following:
  - Even if payments are not “common”, they may be “ordinary”.
  - Creditors should not be discouraged from extending new credit to a customer in questionable financial circumstances.
  - In the case of a first-time transaction, the debt must be ordinary in relation to the debtor’s and this creditor’s past practices when dealing with other, similarly situated parties, where the debtor is not sliding into bankruptcy.
- Payments made. The court concluded the payment was made in the ordinary course of business of the debtor and the transferee, noting that the payment:
  - Was based on an arms-length transaction, and no evidence that C.W. Mining was gambling with creditors’ money
  - Was a progress payment under the contract

- Was made by wire transfer only 2 days early
- Was made from the debtor’s bank account
- Was made without unusual collection efforts by the creditor

The Court also noted that in first-time transactions, the Court may refer solely to the written terms of the transaction to define ordinary course of business.

The 10th Circuit (including UT, WY, CO, NV, KS, OK) noted that three other U.S. Circuits have held that a first-time transaction can qualify for the exception:

6th Circuit (OH, MI, KY, TN)

7th Circuit (IL, IN, WI)

9th Circuit (AZ, CA, NV, ID, MT, OR, WA, AL, HI)

#### The Issue in Delaware and New York

A Delaware Bankruptcy Court ruled that a single transaction can qualify for the ordinary course of business defense. In New York, the cases suggest the defense is not available absent a “baseline of dealings” with the debtor, in which case creditors would have to resort to the alternative ordinary course of business defense, requiring proof the preference period payment was made according to “ordinary business terms.” Eventually, other US Courts of Appeals, including those that cover Delaware and New York, will weigh in on this issue, and potentially create a need for resolution by the US Supreme Court.

We hope you found this useful and informative. Please contact us if you have any questions about this, or any other matter.

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