

# THE Logistics Journal

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## Preferential Payments and the Defense of Payment in the "Ordinary Course of Business" Important Changes in the Bankruptcy Code

By Ronald H. Usem, Esq.

**Many TIA members have received either a demand letter or a complaint from a trustee in bankruptcy demanding repayment of a debtor's payment made within 90 days of filing a bankruptcy.**

The trustee is empowered to collect "preferential transfers" made within 90 days of filing of the Bankruptcy Petition. The theory behind the bankruptcy code section allowing this to happen is that debtors tend to favor their friends as the filing date draws near so that the friends would receive a disproportionate share of payments at the expense of those creditors who are not friends. Thus, the purpose behind recovering the preferential payments is to level the playing field for all creditors.

One of the most commonly claimed defenses for

preferential transfers are payments made "in the ordinary course of business". The Bankruptcy Code lays out the requirements for this defense in 11 USC §547(c)(2) which requires the creditor to show by preponderance of the evidence that the transfers were "(a) made in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor; and (b) made according to ordinary business terms." The burden of proof is on the creditor seeking relief. Generally, a trustee and/or bankruptcy court will take into consideration the entire course of dealing of the parties.

The initial reaction to preferential payment claims is usually one of exasperation and anger. However, after you are done being angry, careful analysis of the payment history of the parties, which is essential to your defense, must be prepared. A careful analysis of the history of the *payments billed and received* needs to be made in order to determine whether, in fact, the payments

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## Preferential Payment *Continued from page 1*

were "preferential" or whether you have a valid affirmative defense, that the payments were received "in the ordinary course of business".

### Upon receipt of a preference claim, this is what you need to do:

1. Contact the trustee, or the attorney for the trustee, and let him/her know that you are in receipt of the claim, and that you will review your accounting information regarding the claim and contact him as soon as possible with a response.
2. Ask for copies of the documents supporting the trustee's claim so that you have an accurate listing of the allegedly preferential payments, their dates, and amounts. Confirm in writing that the trustee or his attorney will do this when you can expect to receive them.
3. If the notice you received is in the form of a complaint, ask for an extension of time in which to research and gather your information as soon as possible. Almost always you will be granted additional time. Get the approval/confirmation *in writing* of the extension from the trustee or his attorney. Do not discuss the merits of the case! Discussion of the merits before you know your payment history can be very damaging to your case.
4. Upon receipt of the information from the trustee, outlining the allegedly preferential payments, dates and amounts, verify that the information is correct. Be careful to analyze whether the allegedly preferential payments *in fact* fall within the 90-day period, following the filing of the Bankruptcy Petition. Do not discuss the merits of the case! Discussion of the merits before you know your payment history can be very damaging to your case. Verify the filing date of the petition.
5. Calculate the number of days between the date of billing and the date of receipt of payment for each payment made *within the preference period*, then calculate the average. It is helpful to place this information on a spread sheet.
6. Next, calculate the average number of days from the date of billing to the receipt of payment *outside* the preferential period, for all payments made within one year of the date of filing of bankruptcy. This calculation will *not include* the allegedly preferential payments. If your payment history does not go back a year, calculate for the number of months that business was conducted *outside* of the preference period.
7. Next, perform the same calculation for *all* payments made (both inside and outside the preference period) going back one year from the date of filing bankruptcy.
8. You may want to go back 18 or 24 months, depending upon your history with the debtor. If going back further helps your average then do it.
9. Place all calculations on a spread sheet.
10. The closer the number of days average *within the preference period* to the number of days average *outside the preference period*, the more likely it is that the payments were received "within the ordinary course of business". Once your calculations are made, you will need to contact bankruptcy counsel in order to research preference cases in the Federal District/Circuit in which the Bankruptcy Court is located in order to determine how close you have to be in order to be successful.
11. *Example:* In a recent case, here are the calculations: A preference claim asserts that \$35,745 was received within 90 days of filing of the Bankruptcy Petition.
12. Calculations reveal the following: The average number of days from billing to receipt of payment during the preference period was 67.2 days.
13. The average number of days from billing to receipt of payment for *all* payments, including the preference period, was 64.6 days. The average number of days for receipt of payments outside the preference period was 63.5 days. Thus, the allegedly preferential payments were received an average of 2.6 *days later* than the average for all payments for the entire year. The numbers are very close which is an excellent result.
14. The average number of days *inside* (90 days) the preference period is 67.2 days. Thus, compared to the preferential payments *outside* the preference period, the allegedly preferential payments were received an average of 3.7 *days late*. This is a good result.
15. Note, a case law indicates that *late payments* may be considered preferential as well as early payments.
16. Thus, the question in the current example case is whether the preferential payments received an average of 3.7 days late were either "preferential" or were received in the "ordinary course of business", and thus are not recoverable by the trustee. The courts look at the established practices of the parties, compare actual practices with agreed upon credit terms, look to see if any unusual collection pressures were placed on the debtor, and take the position that substantial deviations outside normal practices will be considered "preferential". Thus, while a final answer to the question in this case cannot yet be made, case law within the applicable district indicates that payments which are only 3.7 days late are well within the "ordinary course of business between the parties". In this case, there were well over 100 shipments involved.

As you may well imagine, the shorter the payment history, the more difficult it is to establish a course of dealing, and thus prove the ordinary course of business defense. Even if there are just a few payments involved, have your attorney check the cases in your district/circuit to see if there is any precedent that may help you.

### **Significant Change in the Bankruptcy Law Which Became Effective October 2005:**

Under prior bankruptcy law, in order to be successful in asserting the ordinary course of business defense, you also had to prove that the ordinary course of business was within some broader industry practice. This was very difficult and costly to prove. Under the revised bankruptcy law (Title 11 USA §547(c)(2)), as long as the defendant creditor can show either that the transfer was made in the ordinary course of business, or the financial affairs of the debtor and the transferee, or that the transfer was made according to ordinary business terms, then

the Defendant creditor will have a valid affirmative defense to an otherwise voidable preference action. The amendment to the code should reduce the cost of defending a preference action because the defendant will no longer be required to produce expert testimony regarding industry standards.

There are two other important changes in the bankruptcy code: Preference claims under \$5000.00 are no longer allowed; Preference claims that do not exceed \$10,000.00 must be brought in the district in which your business is located. This makes the cost of recovery more expensive to the trustee and thus less likely to start litigation.

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*Ronald H. Usem, Esq., Transportation Attorney, Huffman, Usem, Saboe, Crawford and Greenberg, P.A., presented this paper during the 2005 TransComp and Intermodal Expo in Anaheim, California, November 14, 2005.*

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## **Getting Through the Buzz-words**

*By Steve Blair*

*The January 2006 issue of Logistics Journal carried an article by Mike Solomon titled "Getting the Best Possible Value for Your Software Investment" which described to TIA members what it could cost to invest in basic software applications for their businesses. In the article below, Steve Blair discusses how TIA members can make the best possible software investments to meet their companies' needs.*

**I**n the quick paced world of technology, it seems nearly impossible to keep up... so the real trick is filtering out the noise. Over the years, buzzwords come and go in the computer industry. Client-server, ASP, XML, SQL, SOAP, Web-enabled, data warehouse, EDI, .Net. All terms with specific meanings, but often miss-understood as requirements of a "good" system. Is your software Web-enabled? If the answer is "yes", that's good, right? Probably so, but the real question is what does Web-enabled mean to you and what does it do for your bottom line? Many of these new technologies are new ways to address old problems.

The Lesson here is tunnel through the buzzwords to the business solutions. If the latest craze is ASP, XML, or .Net, always ask "so what?" What does XML do for my bottom line? If someone can't tell you that, you don't need it. Let's compare this to the new double-wide tires. As a broker, you don't care if the truck moving your freight has 18 wheels or 14, that is a benefit to the carrier. As a technology company, we can take advantage of

new technologies to help you solve problems. But your interest is in the solution, not how we did it. Several years ago IBM had a great commercial about web sites. A tech was developing a Web site and a businessman stood behind him asking, "What does it do?" All the tech could answer was "It does flames, aren't they cool?" to which the suit would say "Yes, but what does it do?" Always ask "So what?" and demand an answer.

All current technologies have advantages and disadvantages; there is no one requirement or technology that is inherently better than the others. Some are better at doing certain things, so the first question is what do you need to do and why. Once you make the decision to move to new technology, how do you shop? The most important piece of advice here is to take the decision seriously.

### **Is picking the right software as important as picking your spouse?**

The impact on your business that a TMS system has is similar to picking a spouse, and the wrong decision can have equally dramatic consequences. Done properly, it will grow with you for many years to come and have a tremendous impact on the success of your company. As someone who has dealt with thousands of transportation companies over the years, it is common to hear a new twist on doing something followed immediately by "EVERYONE does it this way". Don't assume that something you have done for years is the way everyone does it. Make sure your selection process covers all the critical functions of your operation and reviews the available products for those capabilities. It is scary how many times we install a system, and after the system is installed, the people trained and ready to go, the owner will inform us of a certain requirement that encompass-