

The Court held that the defendant in a preference action, who was an insider married to the CEO of the Debtor, did not satisfy her burden of proof in establishing an ordinary course of business defense when she received payment of her claims on better terms than other creditors of the Debtor.

***KH Funding Co. v. Escobar (In re KH Funding Co.)*, --- B.R. ---, 2015 WL 7307891 (Bankr. D. Md. November 18, 2015) (Catliota, J.)**

Summary by Justin P. Fasano, McNamee, Hosea, Jernigan, Kim, Greenan & Lynch, P.A.

KH Funding Company (the “Debtor”) was a real estate lender. Occasionally, the Debtor came to own certain real estate property on which it foreclosed, or which it received pursuant to a deed in lieu of foreclosure. These properties were called “Other Real Estate Owned” or “OREO.” In December 2010, the Debtor filed for Chapter 11 bankruptcy. The Debtor confirmed a plan of liquidation in 2012 and thereafter commenced pursuing preference actions, including one against the defendant Aida Escobar (“Defendant”).

The Defendant was a former security guard who met the CEO of the Debtor in 2007, three years before the Debtor filed bankruptcy. In August 2010, four months before the bankruptcy, the Defendant married the CEO of the Debtor.¹ During their relationship, and within a year of the Debtor’s bankruptcy, the CEO of the Debtor told the Defendant that she should provide maintenance services to the Debtor’s OREO Properties. The CEO had no knowledge of the Defendant’s previous experience providing such services.

In the year before the bankruptcy, the defendant was paid \$134,717.15 for maintenance services to the Debtor. The invoices for such services were routinely prepared by the CEO of the Debtor. The CEO would then approve the invoices and then walk them down to the Debtor’s paying department. Each invoice was paid within two days of submission.

Section 547(c)(2) of the Bankruptcy Code provides that:

(c) The trustee may not avoid under this section a transfer –

(2) 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.

11 U.S.C. §547(c)(2). The Defendant asserted only a 547(c)(2)(A) ordinary course of business defense, not a 547(c)(2)(B) ordinary business terms defense. The Court held that “[w]hether a transfer was made in the ordinary course of business of the debtor and the defendant is a subjective inquiry in which the defendant must demonstrate that the disputed payments were

¹ The Defendant had admitted, in her answer and elsewhere, that she was an insider during the entire year before the bankruptcy. In a separate opinion, the Court refused the Defendant’s request to relieve herself of this admission.

ordinary in relation to prior course of dealings between debtor and defendant.” The Court further held that “[c]ourts typically consider four factors in making a determination of whether a transaction is “ordinary” between the parties: (1) the length of time the parties were engaged in the transaction in issue; (2) whether the amount and form of tender differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection or payment activities; and (4) whether the creditor took advantage of the debtor’s deteriorating financial condition.”

In this case, the defendant did not provide any services to the Debtor prior to the year before the bankruptcy. The Debtor, asserting a position espoused by a minority of bankruptcy courts, argued that this lack of pre-preference history alone prevented the Defendant from raising an ordinary course of business defense. The Court rejected this argument and looked instead to the facts of the case.

The Court could not find any cases where an insider had asserted an ordinary course of business defense without any pre-preference period history of dealing with the Debtor. The Court assumed without deciding that if the defendant had been treated on the same terms as the Debtor’s other creditors, such treatment would support an ordinary course of business defense. However, the Court found that the facts of the case showed that the Defendant received favorable treatment. The Court found that the Defendant’s invoices were rudimentary in nature, listing only the hours worked and the hourly rate for such services, without a description of the work provided. Invoices were walked to the paying department by the Debtor’s CEO, and paid within two days. Each payment occurred during a time when the Debtor was in significant danger of being forced to liquidate. Other contractors performing work on OREO property generally were required to submit bids, while the Defendant was not so required. All these facts weighed against an ordinary course of business defense and supported an inference of preferential treatment.

The court also rejected the Defendant’s position that she should only be required to return the profit she received for the services she provided. No authority had been cited for this position.

This decision is currently being appealed.