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In Defeat, Is New Life Breathed Into the "Ordinary Course of Business" Defense?

- Author, Michael T. Perry, Partner, and
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In *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co. (Matter of Gulf City Seafoods, Inc.),* 296 F.3d 363 (5th Cir. 2002), the Fifth Circuit ruled that a preference defendant invoking the "ordinary course of business" defense "must show that as between it and the debtor, the debt was both incurred and paid in the ordinary course of their business dealings *and* that the transfer of the debtor's funds to the creditor was made in an arrangement that conforms with ordinary business terms–a determination that turns the focus away from the parties to the practices followed in the industry." (emphasis verbatim). With this decision, the Fifth Circuit joined the majority of Courts of Appeals by holding that the third element of the "ordinary course of business" defense–"according to ordinary business terms"–requires proof that the parties' course of dealing was consistent with their industry's standard. Thus, a defendant must prove that its transactions with the debtor fell within a range of practices observed between other similarly situated debtors and creditors in "the industry," a standard that the Fifth Circuit, and others, suggest is an "objective" one. Despite the creditor's defeat in *Gulf City*, the decision may in fact breathe new life into the defense by easing the defendant's burden.

Rather than serving as an arrow in a defendant's quiver, the "ordinary course of business" defense has been largely unsuccessful thus far, routinely brushed aside by debtors and trustees as meaningless in all but the very few fiercely litigated preference actions. Notwithstanding the questionable nature of the Fifth Circuit's assertion that the third-prong of the defense is subject to an "objective" standard, the court acknowledged the fuzzy concept of "the industry" in a way that offers a practical approach to preference defendants. In its opinion, the court cited the always pithy, generally singular observations of Judge Posner, "questioning whether the appropriate industry included 'the [sellers] of sausages to makers of pizza? The [sellers] of sausages to anyone? The [sellers] of anything to makers of pizza?')." *Id.* at 369 (quoting *In re Tolona Pizza Products Corp.,* 3 F.3d 1029, 1032-22 (7th Cir.1993)). The Court then stated that a creditor should provide evidence of credit arrangements between other debtors and creditors in similar geographic and product markets:

> In our view, for an industry standard to be useful as a rough benchmark, the creditor should provide evidence of credit arrangements of other debtors and creditors in a similar market,

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PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
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> preferably both geographic and product. We think that the industry benchmark inquiry is best illustrated by application: In this case, Ludwig might provide evidence, to the extent that it is reasonably available, of credit practices between suppliers to whom Gulf City might reasonably turn for its seafood supply and firms with whom Gulf City competes for consumers, from which a bankruptcy judge can determine whether there is some basis to find that the Ludwig-Gulf City arrangement is not a virtual stranger in the industry.

Id.

Although the debtor prevailed in *Gulf City*, the Fifth Circuit's ruling may ultimately help preference defendants because a defendant "may satisfy its burden through testimony by its own company representatives about the practices of other creditors and debtors in the industry, subject of course to applicable evidentiary rules." *Id.* at 368, n.5. This is significant because no "outside" expert testimony is required. The defendant in Gulf City introduced **no** evidence that the allegedly preferential payments were made according to industry standards and, therefore, failed to sustain its burden

Thus, a preference defendant may prevail by using only its own representatives (who have direct knowledge) to testify about practices within a relatively confined "industry," rather than the ungainly process of offering up a parade of witnesses from "the industry." Absent some rebuttal by the debtor/trustee of the preference defendant's own evidence, that may be sufficient to carry the day.

LOWLA Creditors Subordinated to Prior-Recorded Bank Mortgages

- Author, Jeffrey M. Baudier, Special Counsel, and Editor, Nan Roberts Eitel

In *In Re Equinox Oil Company, Inc.*, 300 F.3d 614 (5th Cir. 2002), the U.S. Fifth Circuit affirmed the holding of the Eastern District of Louisiana that pre-existing bank mortgages primed liens filed by certain creditors pursuant to the Louisiana Oil Well Lien Act ("LOWLA").

Equinox Oil Company, Inc. ("Equinox") operated oil and gas leases owned by Alma Energy Corp. ("Alma"). Den norske Bank, ASA, BNP

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Paribas and Comerica Bank- Texas (the "Bank Group") loaned over $106 million to Equinox and Alma, which loans were secured by mortgages and other security interests in all the assets of Alma. In the course of operations, Equinox incurred unpaid debts to numerous vendors and service providers (the "M&M Creditors"), who perfected liens pursuant to the LOWLA against the same property secured by the Bank Group. The mortgages and financing statements of the Bank Group were filed before the effective date of the LOWLA liens.

In September 1998, a blowout occurred at a well on an Alma lease, causing property damage and an oil spill. Numerous companies provided services and equipment (the "Remediation Creditors") to Equinox to stop the blowout and clean up the spill. Equinox's insurer paid Equinox $700,000 in partial settlement of a claim brought by Equinox under its well control policy, and Equinox paid these proceeds to some, but not all, of the Remediation Creditors. In May 1999 Equinox was placed in involuntary Chapter 7 bankruptcy, which Equinox converted to Chapter 11, and in June 1999, Alma also filed a Chapter 11 proceeding. The bankruptcy court consolidated the two proceedings.

The Fifth Circuit, relying on the reasons set forth in the district court's opinion, *In Re Equinox Oil Company, Inc.*, 2001 U.S. Dist. LEXIS 8165 (E.D. La. 2001), held that the Bank Group's mortgage was superior in ranking to the LOWLA privileges of the M&M Creditors. While conceding that their liens arose after the recordation of the Bank Group's mortgages, the M&M Creditors argued that their mechanic and materialmen's liens constituted "Permitted Encumbrances" under the express language of the Act of Mortgage from Alma to the Bank Group. The Act of Mortgage defined Permitted Encumbrances to include "Liens under operating agreements, pooling orders and unitization agreements, and mechanics and materialmen's Liens, and similar statutory Liens for services or materials for which payment is not yet due." The district court focused on the "not yet due" language and interpreted the provision to apply to only those Permitted Encumbrances filed after perfection of the Bank Group's security interest, for work begun before the effective date of that interest.

The district court's interpretation was supported by the testimony of a Houston oil and gas attorney, qualified as an expert, who testified that the term "Permitted Encumbrances" in a mortgage of mineral interests customarily refers to liens that are extant at the time the mortgage is executed. The district court also rejected equitable arguments of the M&M Creditors based on theories of unjust enrichment and the law of accession. In affirming the

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GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY & E-COMMERCE
INTERNATIONAL
LABOR RELATIONS & EMPLOYMENT
MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
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PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
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district court, the Fifth Circuit simply noted the clear language in the LOWLA, which states that mortgages that are effective as to third persons before the privilege is established are superior in rank and priority to the liens. La. R.S. 9:4870(B)(2).

Insurance Proceeds Under Well Control Policy Held to Be Property of the Estate

Also in *Equinox*, the Fifth Circuit considered, apparently for the first time, the issue of whether the proceeds of an indemnification policy which is to reimburse for losses owed to third parties is property of the debtor's estate. On appeal, Equinox's Remediation Creditors argued that because Equinox's well control policy covered Equinox for the cost of work they did in responding to the blowout and spill, the proceeds of the policy should be excluded from the bankruptcy estate and instead paid directly to them. The Fifth Circuit, after reviewing the prior decisions of *In Re Edgeworth* and *In Re Louisiana World Exposition, Inc.* (*LWE*), agreed with the district court that proceeds of the policy belong to the bankruptcy estate.

The Fifth Circuit noted that the definition of property included within the bankruptcy estate under Section 541 of the Bankruptcy Code covers "all legal and equitable interest of the debtor in property as of the commencement of the case" and "proceeds . . . of or from property of the estate." It further noted that an insurance *policy* owned by the debtor is generally considered property of the estate. The central question, however, as developed in *Edgeworth* and *LWE,* for determining whether insurance proceeds associated with a policy are property of a bankruptcy estate is whether, in the absence of the bankruptcy proceeding, the proceeds of the policy would belong to the debtor when the insurer pays a claim. When the insurer's payment cannot inure to the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate.

In applying this principle to the Equinox policy, the court noted that the policy named Equinox as the Assured and that the Remediation Creditors were not named as loss payees under the policy. Under the policy, the underwriters agreed to "reimburse the Assured" for expenses incurred in relation to well blowouts. Therefore, the court concluded, the policy covered losses of Equinox itself and provided for payment of those losses to Equinox. The Remediation Creditors had no right under the policy to claim its proceeds, nor was the policy designed to protect the losses of third parties, as were the policies involved in *Edgeworth and LWE.* While recognizing that the position of the Remediation Creditors had an "equitable tug," the court pointed

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GOVERNMENT RELATIONS
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MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
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out that those creditors were not unlike other unfortunate creditors whose debts are owed but who cannot establish a priority under state law or the Bankruptcy Code to advance their priority over other general creditors.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact our Bankruptcy practice group:

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