eCredit news
Credit Professionals Alliance, Inc.
March
2024
Volume 261

e contents

The eCredit News is produced in partnership with the NACS Credit Services, Inc.

The Lurking Danger of Artificial Intelligence: Greater Preference Exposure

By: Joseph Frank & Jeremy Kleinman, FrankGecker LLP

Recent growth in the use of artificial intelligence ("<u>AI</u>") is changing business processes at a rapid pace, and the management of credit relationships is not immune from this influence. Indeed, AI can use machine learning and predictive analytics to better identify customers at risk of non-payment and to communicate effectively with those customers to optimize collection. Used correctly, these tools can be a valuable part of credit management and may enhance the ability to get payments in the door. But if the customer making those payments is insolvent and ends up in bankruptcy, the use of AI may impact a creditor's ability to keep those payments and create exposure to preference liability under section 547(b) of the United States Bankruptcy Code (11 U.S.C. §§ 101 *et seq.,* hereinafter, the "<u>Bankruptcy Code</u>").

<u>Preferential Transfers and Defenses</u>
We begin with a quick primer on preference liability under section 547(b). Subject to a few enumerated affirmative defenses, a debtor or trustee in bankruptcy may generally avoid and recover as "preferential" a transfer of an insolvent debtor's property (over a threshold amount) made on account of an unsecured antecedent debt within the 90 days prior to bankruptcy.

Continued...

March Dates To Remember:
10th: Daylight Saving Time Begins
17th: St. Patrick's Day
24th: Palm Sunday
29th: Good Friday
31st: Easter Sunday

While this definition of "preferential transfer" seems to capture virtually every payment made by a debtor to its unsecured creditors during the 90 days before its bankruptcy filing, section 547(c) of the Bankruptcy Code provides affirmative defenses that can shield a creditor from liability. The two most commonly used defenses are:

(i) the "subsequent new value" defense under section 547(c)(4), providing a dollar-for-dollar reduction of preference liability for additional unpaid goods or services provided after payment of one or more of the alleged preferential transfers; and

(ii) the ordinary course of business defense under section 547(c)(2), protecting payments made consistent with either the prior history of the parties' credit practices, or the "ordinary business terms" of the creditor's industry. These alternative criteria are presented disjunctively in section 547(c)(2). However, some courts have suggested that intensified collection efforts could invalidate a defense under *both* alternative prongs of section 547(c)(2). *See In re: Lyondell Chemical Company,* 2015 WL 5560283, at *9 (Bkrtcy.S.D.N.Y., 2015) ("the Court notes that there is nothing in the record indicating that LR2 took any 'extraordinary collection efforts' that could jeopardize the . . . satisfaction of the elements of the ordinary business terms defense). Furthermore, to prevail on an ordinary course of business defense based on ordinary business terms, a creditor "must provide admissible non-hearsay testimony related to industry credit payment, and general business terms in order to support its position." *FBI Wind Down, Inc. Liquidating Tr. v. CareersUSA, Inc. (In re FBI Wind Down, Inc.),* 614 B.R. 460, 495 (Bankr. D. Del. 2020). Where a defendant presents only its own practices without any general industry standards for comparison, it has not met its burden. *Id.*

AI Credit Management and the Ordinary Course Defense

So, what does this have to do with AI? Potentially, a lot. The latest AI credit management tools can:

- prepare reports identifying customers at heightened risk of delaying or missing payments;
- analyze customers communications to predict willingness and ability to pay;
- identify effective times and methods for communicating collection demands to specific customers; and
- generate automated collection communications or demands, with language customized to optimize payment prospects from each specific customer.

Continued...

Used correctly, these tools can bring greater efficiency and, perhaps, effectiveness to the credit management process. However, these tools also can generate documentary evidence of identified risks and resulting changes in collection efforts, including changes to frequency, methods, tone, and substance of collection demands, and even escalating threats, any, or all of which could undermine an ordinary course of business defense. *See, e.g. In re hhgregg, Inc.*, 2022 WL 370279, at *9 (Bankr. S.D.Ind., 2022) (court found that payments were non-ordinary due in part to increased communications with debtors about the need for payment that included threats of held shipments and frequently included members of the debtors' and creditor's senior management); *In re Roberds, Inc.*, 315 B.R. 443, 467 (Bankr. S.D. Ohio 2004) (rejecting ordinary course of business defense when payment terms changed, and credit holds took place). Indeed, a plaintiff in preference litigation would be wise to take discovery relating to (i) the use of AI in connection with the credit relationship, (ii) when AI identified the debtor as a credit risk, and (iii) how the treatment of, or interactions with, the debtor deviated from prior treatment of that debtor and the treatment of other customers.

While it is easy to envision a time when using AI as an essential credit management tool ***is*** ordinary in a creditor's industry, that time has not yet come, and the interplay between AI and a creditor's potential defenses to a preference claim has not yet been explored by bankruptcy courts. Indeed, to a bankruptcy judge who may lack experience using AI in the operation of a business, these AI collection processes may be strong evidence that transfers were not ordinary and cannot benefit from the ordinary course defense.

AI on AI Collection

Don't just take our word for it. We asked ChatGPT "does the use of AI to manage a credit relationship have potential impact on an ordinary course of business defense to a preference claim under section 547(c)(2) of the Bankruptcy Code?" Here was part of its response:

I am not a lawyer, but I can provide some general information that may help you understand the situation. However, for legal advice specific to your case, it's important to consult with a qualified attorney.

Section 547(c)(2) of the Bankruptcy Code provides for the "ordinary course of business" defense to preference claims. This defense allows a creditor to argue that the payment or transfer being challenged as a preference was made in the ordinary course of business between the creditor and the debtor.

Continued...

The use of AI to manage a credit relationship could potentially impact the ordinary course of business defense in a preference claim, depending on how the AI system is utilized and its effects on the payment transactions. Factors that might be considered include:

1. **Change in Payment Patterns:** If the AI system significantly changes the historical payment patterns between the debtor and the creditor, it could potentially weaken the ordinary course of business defense. This might happen if the AI system leads to substantially different timing or amounts of payments compared to the past.
2. **Predictive Analysis:** AI systems may use predictive analysis to determine payment schedules. If the AI's predictions differ significantly from past practices, it could impact the creditor's ability to establish a consistent ordinary course of business defense.
3. **Influence on Timing and Amounts:** If the AI system influences the timing and amounts of payments, and these changes are deemed unusual or inconsistent with historical practices, it could impact the creditor's ability to establish that the payments were made in the ordinary course of business.

* * * *

Practical Steps

So, what should you do? Here are some suggestions:

- Pay attention to the communications generated by AI. If AI is being used to collect outstanding invoices, significant changes in the AI communications can signal that a customer presents an enhanced or even imminent credit risk, which may require special attention to pursue payment while trying to avoid preference liability. At the same time, if a customer does seek bankruptcy protection and seeks to recover preferential transfers, the written communications between the debtor and creditor will likely be scrutinized by attorneys (and, perhaps, a bankruptcy judge) who are otherwise unfamiliar with the parties' business dealings. They may interpret changes in the method, frequency and substance of those communications as undermining an ordinary course of business defense to a preference claim.

  Address the high-risk customers personally. Once an enhanced risk customer is identified, there are steps a credit manager (or AI) can take to address the situation, including shortening payment terms, shifting to CIA or COD, or demanding a deposit or letter of credit, any of which may limit losses in the event of bankruptcy. However, each of these steps can have a range of other adverse consequences. Depending on the importance to the debtor of the goods or services being provided and the debtor's liquidity, a change to CIA or COD or demand for security could also impact the debtor's continued viability, speeding its descent into bankruptcy. Furthermore, any of these credit actions, or even a written threat to take these actions, could constitute a departure from "the ordinary course of business," putting future payments on antecedent debt at risk without the protection of the ordinary course of business defense. Personal involvement when a customer presents significant risk of substantial loss or preference liability can ensure that all the potential consequences of any credit action are carefully considered (including, when necessary, through the involvement of counsel) and that action and communication are tailored to minimize and balance those risks.

Continued..

- Integrate industry norms and practices into your AI designs and directives. Because section 547(c)(2) protects payments that are either consistent with the parties' prior business practices or the business terms, norms and practices that are ordinary in the creditor's industry, those terms, norms, and practices can be integrated into an AI collection program. While the "ordinary business terms" defense is typically established by expert testimony regarding (i) the ordinary business terms in a creditor's industry, and (ii) whether the payments were received consistent with those terms, evidence of the use of ordinary business terms in AI-based credit management (and no actions that deviated from those terms) could bolster this affirmative defense.

- Get the Payment. Even if a payment is obtained through collection efforts that depart significantly from the ordinary course of business, it may still be protected by the subsequent new value defense under section 547(c)(4), but if it is not, creditors will typically have the opportunity to settle any preference liability at a discount and may have an opportunity to resolve any preference liability through a full or partial waiver of an administrative expense or general unsecured claim. This can often provide a creditor with a greater recovery than refraining from any additional collection efforts and being paid as an unsecured creditor in the customer's bankruptcy.

Ironically, when asked how to minimize risk to the ordinary course of business defense from using AI in credit management, ChatGPT provided the most important advice: "Remember that the specific impact of using AI in a bankruptcy case can vary based on factors such as the nature of the AI system, the industry involved, and the overall business relationship. Working closely with legal professionals who have expertise in bankruptcy law is essential to ensure that your use of AI aligns with legal requirements and best practices."

About the Authors:

Joe Frank is bankruptcy counsel to some of the largest public and private corporations in the United States. He provides daily counsel to these companies on both routine and complex bankruptcy matters and has appeared on behalf of his clients in bankruptcy courts throughout the country. He also represents creditors' committees and asbestos claimants' committees and has confirmed Chapter 11 plans on behalf of committees in bankruptcy courts in Delaware, Illinois, Missouri, Wisconsin and New York. As a member of the Trial Bar for the Seventh Circuit Court of Appeals, Joe often represents bankruptcy trustees and creditors in bankruptcy court litigation, and he has filed Chapter 11 bankruptcy cases and handled workouts for mid-sized corporate debtors, including many real estate developers. He does not represent banks, and dedicates much of his practice to helping debtors and unsecured creditors get their fair share in bankruptcy.

Jeremy Kleinman's practice includes the representation of secured and unsecured creditors, commercial landlords, creditors' committees, trustees and other clients in all stages of Chapter 11 bankruptcy proceedings. He also has extensive experience litigating preference and fraudulent conveyance avoidance actions, claim disputes and other bankruptcy-related disputes. Recently, Jeremy confirmed a Chapter 11 plan on behalf of the official committee of unsecured creditors in the Chapter 11 bankruptcy case of a local snack food manufacturer. Although the debtor in that case had few liquid assets at the time of the bankruptcy filing, creditors obtained a 52% recovery through the committee's pursuit of litigation against certain insiders of the debtor.

As originally published in Perspective by CRF 3Q2023


STOP
LOSS

MARCH WEBINARS

Credit Professionals Alliance has been working hard to provide our clients with the most up-to-date webinars concerning today's challenges in the credit field. Watch your email for upcoming registration information on all of the following webinars.

March 6th:	**Conflict Resolution**
March 26th:	**Escheatment—What to know if the State Audits your Company**

Be sure to check out our website www.nacskc.com/education.html for additional educational opportunities as these are constantly being updated.

Are you looking for Certification and Certificate opportunities? Credit Professionals Alliance can lead you in the right direction, contact Rhonda Ross for additional information at rross@nacskc.com or (913) 383-9300.

Educational Update:
Credit Research Foundation Webinars

March 2024

CRF offers a variety of educational programs: Proctored Courses, On-Demand Courses as well as webinars.

March 18-20, 2024	March Forum—Charleston, SC
August 5-7, 2024	August Forum & Expo—Nashville, TN
October 21-23, 2024	October Forum—National Harbor, MD

It is very simple to participate: Go to http://www.crfonline.org and click on the Education.

Now offering a Certificate Program!

For additional information go to http://www.crfonline.org/events/current.asp

The following webinars are being offered by NCS Credit
to register for these go to: www.ncscredit.com/education-center/webinars

March 26, 2024
Webinar: An Advanced Look at the Lien & Bond Claim Process

April 2, 2024
Webinar: Everything You Should Know about Correctly Identifying Your Debtor Under Article 9-503(a)

NCS®
Securing Your Tomorrow