collective szabo wisdom®

SZABO ASSOCIATES, INC. VOLUME 10, ISSUE 1, MARCH 31, 1995

Dear Friends:

Here in Atlanta we always welcome Spring, when the weather turns balmy and our city blooms with dogwoods. This particular season, we have much for which to be thankful.

January 31st marked the midpoint of our current fiscal year. We are pleased to report that this fiscal year is Szabo Associates' most successful since the business was founded in 1971. We thank our valued clients and associates who have helped us grow, evolve, and prosper over the last two decades.

As a creditor, your company may at some time find itself challenged with regard to a payment deemed "preferential." This issue's feature article focuses attention on a common defense to the "voidable preference attack." We would like to thank attorney Arnold Quittner for his contribution to our newsletter on this important subject.

Be sure to check out the Calendar of Events for the season's goings-on, and have a wonderful Spring!

Best wishes,

Pete Szabo, President
Szabo Associates, Inc.

Received Payment from an Insolvent Debtor?

Hang On To Your Money with the Ordinary Course of Business Defense!

Szabo Associates, Inc. would like to thank Arnold M. Quittner, Attorney at Law, for contributing the following article. Mr. Quittner is a partner specializing in bankruptcy and reorganization in the law firm of Stroock & Stroock & Lavan in Los Angeles, California [phone (310) 556-5800].

In olden days of common law, nothing barred a merchant from choosing one creditor over another in the payment of debts. A debtor facing insolvency could simply pay off relatives and creditors he liked, leaving nothing for everyone else. Almost from the beginning of bankruptcy laws in England, however, a trustee in bankruptcy was able to pursue recovery of preferential payments to unsecured creditors.

Two Congressional policies underlie the provisions regarding what are known as "voidable preferences." First, recovery of the preferential payment promotes the primary bankruptcy policy of "equality of distribution among creditors" by insuring that all creditors of the same class receive the same pro rata share of the debtor's estate. Second, the threat of recovery discourages creditors from attempting to outmaneuver each other in a mad rush to the courthouse or in an effort to carve up the financially unstable debtor, and, perhaps provides the debtor with an opportunity to work out its financial difficulties in a more consensual atmosphere.

For a payment to be deemed preferential, the trustee must prove: (1) that a transfer of the debtor's assets was made; (2) to or for the benefit of the creditor; (3) for, or on account of, an antecedent debt (a debt incurred prior to the payment); (4) while the debtor was insolvent on a balance sheet test; (5) within 90 days prior to the filing date of the bankruptcy (unless the transfer is to an insider, in which case the period is up to one year); and (6) the effect of which is to give the creditor more than the creditor would otherwise receive in a Chapter 7 liquidation.

As a creditor, your company may receive a payment deemed preferential, and if challenged by the trustee, you may be required to repay this money. The Bankruptcy Code provides certain defenses to the "voidable prefer-

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Hang on To Your Money

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ence attack," one of the most common being the "ordinary course of business" defense. The purpose of this defense is to leave undisturbed normal financial relations, because doing so does not compromise the general policy to discourage unusual actions by either the debtor or its creditors during the debtor's slide into bankruptcy.

To establish the ordinary course of business defense with regard to a payment in question, the defendant creditor must prove "by a preponderance of evidence" that the following is true:

1. The payment was of a **debt incurred** by the debtor in the ordinary course of business or financial affairs of both the debtor and the creditor.
2. The **payment was made in the ordinary course of business** or financial affairs of both the debtor and the creditor.
3. The **payment** was made **according to ordinary business terms.**

It is usually easy for the creditor to prove that the debt was incurred in the ordinary course of business. The more difficult question is whether the payment was similar in method and timing to former payments made by the debtor to the creditor. On the other hand, does it appear to be extraordinary, or "abnormal," or was it the result of particular pressure brought against the debtor?

Even if the history of the dealings between the debtor and the creditor shows it to be ordinary, the creditor must show also that the payment is not so peculiar or abnormal as to fall outside the range of terms common within its industry (however that industry is defined).

The Bankruptcy Code does not define payment made "according to ordinary business terms." Usually the creditor contends that the payment should not be deemed outside of ordinary business terms if it was consistent with the transactions between the debtor and the particular creditor in their prior pre-insolvency dealings. A majority of the Federal Courts of Appeal which have addressed this issue have held, however, that such a contention must be tested by an objective analysis. Are the payment's terms usual when compared with the prevailing standards in the creditor's industry? In other words, the benchmark for "ordinariness" is the norm in the creditor's industry.

Congress had reason to favor objective analysis. If the debtor and creditor dealt on terms that were normal between them but totally unknown in the industry, then there may be some doubt as to the testimony of the defendant creditor. Additionally, having an objective standard might dispel creditors' concerns that someone may have worked out a special deal with the debtor before the preference period, designed to put that creditor ahead of the others in the event of bankruptcy.

A 1993 case, In re Tolona Pizza Products Corp., established that the creditor does not need to prove that a single uniform set of industry-wide credit terms exists, because in any industry there may be great differences in billing practices. The Court must look to the "norm" in the creditor's industry and "only dealings so **idiosyncratic** so as to fall outside [a] broad range [of industry practice] should be

collector's corner

"Collector's Corner" is our readers' forum for suggestions, comments, and idea swapping. If you have information to share or input on how our newsletter can better serve you, please write or call. We want to hear from you!

Question: What should I do if I receive a notice of a preference action?

L.N., Augusta, ME

Answer: A notice of a preference action should demand your immediate attention!

1. Inform upper management.
2. Pull the entire payment history on the account. Calculate the number of days from the billing date to receipt of payment for every invoice.
3. Make sure that you did in fact receive payment for those cited as preferences.

This will begin your initial defense process. Please remember . . . time is of the essence!

deemed extraordinary . . ."

A 1994 case, In re Molded Acoustical Products, Inc., even suggested that it would be unusual for an entire industry to have a single set of credit terms and still be consistent with anti-trust policy. This case permitted an even greater departure from the range of "normal" terms if the relationship between the debtor and creditor prior to the insolvency was of longer duration and consistent.

Conversely, if the debtor/creditor relationship is relatively new, the industry norm becomes crucial. And, if the parties' long-standing credit terms, although consistent between them, depart "so grossly from what has been established as the pertinent industry norms that they cannot be seriously considered usual and equitable with respect to other creditors," then the defense will not hold up.

The Molded Acoustics decision protects the usual credit transactions of a company's established creditors and encourages those creditors to extend credit when a business is in trouble times. This gives the troubled business a chance to work out of its financial difficulties and perhaps to side-step an imminent bankruptcy proceeding. Additionally, the likelihood of unfair over-reaching by a creditor to the disadvantage of other creditors is reduced if the parties have maintained the same relationship for a substantial period of time prior to the debtor's insolvency.

In another 1994 case, Advo-Systems, Inc. v. Maxway Corp., the Court adopted the objective analysis of Tolona Pizza, as expanded by Molded Acoustics, and indicated it is possible for the "industry" to consist of a single creditor and its practices.

In Advo-System, the defendant creditor failed to present evidence of the credit terms it normally extended to its other customers similar to the debtor. Advo should have presented **specific** evidence of its specific credit terms representative of its norm (for example, the manner, form, amount, and timing of its customers' credit payments). Instead, Advo presented a general characterization—its "norm was to work with its customers and to extend credit to some customers instead of requiring pre-payment." Apparently, Advo usually required pre-payment rather than extending credit. The waiver of a pre-payment and allowing the debtor to pay when it could was a "gross departure" from Advo's norm; accordingly, Advo could not show that the preference payments were made according to ordinary business terms.

Clearly, the defense of ordinary course of business has been expanded over time, and anyone faced with providing a burden of proof in an ordinary course of business defense should pay attention to these very recent decisions by the Appellate Courts. If you are a voidable preference defendant, it would be wise to do the following:

1. Take the time and make the effort to **determine your industry standard.** This should be a fact-intensive search!

2. **Compare the industry standard with the history of dealings between the debtor and you,** the defendant creditor. If your practices with the debtor, including the payment in question, are consistent with industry practices, your defense is much stronger.

3. **Consider the duration of your relationship with the debtor.** The longer and more consistent the relationship, the more likely it is that you will have a viable ordinary course of business defense, even if your credit terms fall somewhat outside the industry norm. ♦

"I KNOW ALL ABOUT 'PREFERENTIAL TRANSFERS.' WHEN MY FRIEND LORETTA'S HUSBAND PREFERRED TO TRASFER HIS AFFECTIONS TO ANOTHER WOMAN, LORETTA PREFERRED TO TRANSFER ALL THE MONEY IN THEIR JOINT BANK ACCOUNT OUT OF THE COUNTRY."

Why We Work the Way We Do
Our People

The essence of the collection process is simple: a one-on-one conversation. It consists of one of our representatives on a telephone with someone who represents your past-due account.

At Szabo, our entire organization is dedicated to giving our representative a powerful advantage in that conversation.

If any single factor accounts for our success in recovering media receivables, it's our people—the way we choose them, train them, support them, and motivate them.

We start with a very stringent hiring process. We look for a unique combination of personality, intelligence, self-reliance, and an ability to learn from training and experience. Many candidates already have experience in collection or in media.

Our training program covers debtor and creditor rights, and the negotiation and persuasion techniques involved in collecting. But most of all, we train our people to be experts in our clients' business. Today, our people receive specialized training in the division in which they work—TV, radio, magazines, newspaper, or cable, as well as other specialized media and related fields.

Each representative is supported by the world's most complete database on advertisers and agencies, a Library Resource Center, an experienced administrative group, a paralegal department, a nationwide network of collection attorneys, and more.

We use a Total Quality Management system, incorporating an MBO plan. Quality awards are presented annually, and backed by monetary incentives in the form of performance bonuses and a fully-funded profit-sharing plan.

As a result, our personnel turnover is only a fraction of that of most other collection agencies. A third of our people have been working for Szabo Associates 10 years or more.

We figure, the more good people we keep working for us, the more good people we can keep working for you. ♦

Calendar of Events

April 6-9
Commercial Law League of America
Westin Hotel
Chicago, Illinois

May 21-24
Broadcast Cable
Financial Management Association
Mirage Hotel
Las Vegas, Nevada

June 10
Szabo Associates Company Picnic
The Hyde-away, Lake Lanier
Sugarhill, Georgia

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