collective szabo wisdom®

SZABO ASSOCIATES, INC. VOLUME 11, ISSUE 3, SEPTEMBER 30, 1996

Dear Friends:

It's been quite an exciting summer here in Atlanta. Not only did our city host the Summer Olympics, but also the Szabo offices got a new look (new carpets, wallpaper, etc.) and a 1600 sq. ft. expansion. Speaking of international events, Szabo's international business has enjoyed considerable growth over the last few months. And recently, we wrapped up our fiscal year with our annual Szabo Quality Awards Banquet, where individuals were recognized for their excellence in satisfying customers' needs and expectations. These achievements are an integral part of the company's commitment to Total Quality Management.

I look forward to speaking on October 1st at the Yellow Pages Publishers Association convention in Marco Island, Florida. Also on our calendar of events for fall is the Advertising Media Credit Executives Association convention on October 13th through 16th at the Royal Sonesta Hotel in New Orleans, where we'll host another Szabo 25th anniversary party for delegates. And finally, we'll celebrate the close of another great year at our annual Szabo Christmas Party on December 7th at the Hellenic Center in Atlanta. Hope to see many of y'all there!

Pete Szabo, President
Szabo Associates, Inc.

Involuntary Bankruptcy Petitions — Is It Worth the Trouble?

We wish to thank Henry DeWerth-Jaffe, Attorney at Law, for contributing the following article. Mr. DeWerth-Jaffe is an attorney in Philadelphia with the national law firm of Pepper, Hamilton & Scheetz, is a member of the bar in Delaware and Pennsylvania, and practices throughout the country in the areas of bankruptcy, creditors' rights and commercial litigation.

As an experienced trade creditor, you are undoubtedly familiar with the circumstances that lead to the filing of a bankruptcy case. Here is one typical scenario: An account debtor fails to pay you. All attempts to collect bring unsatisfactory results. You hire a lawyer to sue the debtor in state or federal court. The commencement of the lawsuit fails to convince the debtor to pay. You obtain a judgment in your favor. Unfortunately, the debtor is still unwilling to pay up. Here's another scenario: You choose not to sue after finding out that other creditors before you have sued the debtor, obtained judgments in their favor, and failed to collect. At that point you may decide that the debtor's assets probably will have dissipated to nothing by the time you go to trial since it is not uncommon for lawsuits to get bogged down in the courts for several years.

Even if you obtain a judgment, your primary goal is still to *get paid* ahead of other creditors. You attempt to liquidate the debtor's personal and real property using various execution methods permitted outside of bankruptcy, such as a levy or an attachment. If you cannot substantially satisfy the debt through these procedures, you then consider forcing the debtor into bankruptcy.

An obvious question is, what purpose would it serve? Putting a debtor into bankruptcy *may* lead to a greater net distribution for you. Once a debtor is declared bankrupt (or, in bankruptcy parlance, once an "order for relief" is entered), the debtor or a bankruptcy trustee is permitted to attack certain transactions that occurred before the bankruptcy case was filed. For instance, the debtor or trustee may set aside as bankruptcy "preferences" certain transfers made to its creditors 90 days (or in the case of payments made to the debtor's insiders, one year) before the bankruptcy petition was filed. These lawsuits brought during a bankruptcy case (commonly referred to as bankruptcy "adversary proceedings") may increase the pool of assets available to the debtor's unsecured creditors. Additionally, because the business of a bankruptcy debtor is supervised by the Bankruptcy Court, the filing of a bankruptcy petition is likely to prevent further mismanagement or improper transactions that may have occurred before the bankruptcy case was filed.

There are other reasons that you might get a better result if a debtor is forced into bankruptcy. Perhaps the debtor, although

—continued on page 2

Involuntary Bankruptcy

—continued from page 1

currently unable to pay debts as they come due, could pay its unsecured creditors a greater pro rata distribution under a plan of reorganization. Also, by filing a bankruptcy case, you stop other unsecured creditors that may be further along in the execution process from obtaining sole possession of certain of the debtor's unencumbered assets. And perhaps most important, any costs arising in a bankruptcy case, including the cost of prosecuting adversary proceedings, are absorbed by the entire bankruptcy estate, and are not paid by any particular creditor.

So how do you determine whether filing an involuntary bankruptcy petition will be cost effective? Attempt to discover facts showing that the debtor might have valuable causes of action that would increase the value of the bankruptcy estate. The best way to obtain such information might be to serve the debtor with post-judgment discovery in the court in which you obtained a judgment against the debtor (commonly referred to as "discovery in aid of execution") such as interrogatories and document requests. Through this discovery, you might obtain not only relevant financial data from the debtor but also information that would uncover payments or transactions that could be subject to attack in the bankruptcy court. You may wish to follow up this written discovery with a deposition of the debtor's chief financial officer or the person in charge of the debtor's accounts payable department. You might also obtain credit reports from a credit reporting company or hire an asset search firm to determine the status and location of the debtor's assets.

Inquire about the existence of secured creditors, other unpaid unsecured creditors (and the amounts owed to them), the value of the debtor's encumbered and unencumbered assets, whether the debtor is generally not paying its debts as they come due, and whether a custodian is in possession of some or all of the debtor's assets. As you will see, this information is relevant to the filing of a successful involuntary bankruptcy petition.

Let's now assume that you determine that filing an involuntary bankruptcy case could increase your net recovery. Should you proceed to file? Not yet! There are other matters you need to address first. For instance, consider taking steps to ensure that you cannot become a victim of a preference lawsuit (see *Collective Wisdom*, March 31, 1995). Ordinarily, you should not file the petition until more than 90 days (or, if you are an insider, one year) have passed since you received a transfer from the debtor in satisfaction of an outstanding unsecured debt. If you have received a check from the debtor, you and your attorneys must be mindful that, according to the U.S. Supreme Court, a transfer by check is deemed to occur for preference purposes when the check is *honored* by the debtor's bank, *not* when the creditor first *receives* the check from the debtor. Furthermore, if you continue to do business with the debtor, you may require the debtor to pre-pay for future services (pre-payments cannot be avoided as preferences) or demand a deposit sufficient to cover the payment on each future invoice (a deposit will likely give you a secured claim; payments on secured claims are also not preferences).

How to File an Involuntary Petition

Before filing, determine whether you can satisfy the requirements of section 303 of the Bankruptcy Code. Although these requirements appear relatively straightforward and easy to satisfy, creditors often find, much to their dismay, that the filing of an involuntary petition leads to time-consuming and expensive litigation with the debtor.

You may file a bankruptcy petition against a debtor under either Chapter 7 or Chapter 11 of the Bankruptcy Code. Under Chapter 7, all of the debtor's assets are liquidated by a statutorily appointed trustee who can sue for preferences, fraudulent conveyances and any other right possessed by the debtor. Chapter 11 is a bankruptcy reorganization during which the debtor is permitted to operate its business and to exercise the authority to sue for preferences, fraudulent conveyances and the like. It should be noted, however, that even if you file a successful involuntary Chapter 7 petition, the debtor has the right to convert the proceeding to a case under Chapter 11. The debtor would thereby ordinarily regain the right to operate its business and to pursue lawsuits, as previously described.

As a general rule, the petition must be filed by at least three or more entities (including individuals) holding unsecured claims that are not contingent as to liability or the subject of a bona fide dispute, and the aggregate amount of these claims must be at least $10,000. If, however, there are fewer than 12 creditors (excluding any employee or insider of the debtor or any transferee of a transfer that may be set aside under certain provisions of the Bankruptcy Code) that meet these criteria, then the petition may be filed by one or more such creditors holding claims against the debtor in the aggregate amount of at least $10,000.

In most cases, therefore, it is advisable to have at least three creditors jointly file the peti-

tion. This is not a requirement that should be taken lightly. Although section 303 of the Bankruptcy Code permits other creditors to be added to an involuntary petition after the initial filing, many courts hold that if a creditor knew, or had reason to know, that more creditors were needed to properly file, then no additional creditors may be added to the petition. This may result in the dismissal of the involuntary petition.

Furthermore, as previously noted, the claims of the petitioning creditors must not be contingent as to liability or the subject of a bona fide dispute. Claims are contingent as to liability if the debtor's duty to pay is hinged on some external event or contingency; in other words, the creditor does not have the *unconditional* right to obtain payment now. Each claim will be classified as not subject to a bona fide dispute if the debtor has no objective factual or legal basis to dispute the validity of the debt. In short, before you agree to join with other creditors to file an involuntary petition, you must do your homework to ensure that their claims as well as yours clearly satisfy the requirements of the Bankruptcy Code.

If the creditors meet all of these requirements and file their involuntary petition, then the bankruptcy case proceeds like an ordinary bankruptcy case, right? Wrong. The petition is treated like a complaint in a lawsuit. After the petition is served, the debtor has 20 days to file defenses and objections with the bankruptcy court. If the debtor defaults, the petition will be granted after the 20-day period elapses. If the debtor contests the petition, the parties may then conduct discovery, such as filing document requests and taking depositions. Meanwhile, the bankruptcy court may require petitioning creditors to file a bond to indemnify the debtor for any damages that may be allowed if the involuntary petition is dismissed.

If the debtor contests the petition, the issue of the propriety of the involuntary petition may proceed to trial. At trial, the debtor may contest whether the claims of the petitioning creditors are sufficient to permit them to file the petition (that is, whether they are sufficient in amount, not contingent as to liability and not subject to bona fide dispute). Furthermore, to obtain an order for relief commencing the bankruptcy case, the petitioning creditors must show either that 1) the debtor is generally not paying debts not subject to bona fide dispute as they come due; or 2) within 120 days before the filing date of the petition, a custodian was appointed or took possession of the debtor's property (other than a trustee or similar party taking possession of less than substantially all of the debtor's property for the purpose of enforcing a lien).

If the petitioning creditors are unable to prove their case, the debtor may recoup its costs and/or attorneys' fees if the petition is dismissed other than on the consent of all the petitioners and debtor, and if the debtor does not waive its right to obtain a judgment for damages. Indeed, courts often hold that there is either a presumption that costs and attorneys' fees will be awarded to the debtor or that the petitioning creditors must bear the burden of proving that such an award is not appropriate. In addition, if the court finds that the petition was filed in bad faith, the court may award the debtor damages proximately caused by the filing, as well as punitive damages. (As one sobering example, in 1989, a court in New Jersey awarded a debtor punitive damages of $500,000 against a petitioning creditor!)

Finally, most cases hold that before an involuntary petition can be dismissed upon the consent of the petitioners and the debtor, notice of the proposed dismissal must be given to all of the debtor's petitioning and

—continued on page 4

"HEY BOSS, I FINALLY FOUND OUT THE PRINCIPALS OF THAT COMPANY YOU ASKED FOR. THEY SAID THEY WERE. HONESTY AND INTEGRITY."

Involuntary Bankruptcy

—continued from page 3

non-petitioning creditors. Furthermore, a court will probably not dismiss an involuntary petition upon the approval of the debtor and petitioning creditors if the dismissal is deemed to be "collusive" and has the effect of preferring the petitioning creditors over similarly situated non-petitioning creditors. Therefore, a trade creditor should hesitate before using an involuntary petition as a collection device to obtain a strategic advantage over similarly situated unsecured creditors.

The decision to file an involuntary bankruptcy petition is not for the light of heart. If you are considering whether to file an involuntary petition, ask yourself three basic questions: 1) Will a successful petition significantly increase the amount that I could expect to recover through a non-bankruptcy civil suit and post-judgment execution procedures? 2) Will the filing of an involuntary petition be a cost effective alternative? and 3) Will my petition be successful? Unless the answer to each of these three questions is a clear "yes," proceed with caution! ♦

Why We Work the Way We Do Risk Management

The smartest time to begin thinking about collections is not the day you realize a payment is past due. It's the day you consider issuing credit to a customer.

Managing your credit risks is probably one of the most important parts of your business. We believe Szabo Associates does more to help you with Risk Management than any other collection service.

Do you need information on ad agencies and advertisers? You can get quick answers from the Szabo Credit Information System. It's our own historical data base of 200,000 companies, based on our credit experience with them.

Our Management Reports give you another source of data. In our Corporate report, you can analyze the questionable credit performance of a customer of one of your properties, before credit is extended by your other properties.

You can call on Szabo Consulting Services to help you with Risk Management advice that's customized to your situation. We can provide your own industry's credit barometers—DSO, Aging and Bad Debt. We can give you helpful legal information from our Resource Center Library—creditor/debtor rights, liabilities, and laws and court cases covering credit and collections.

We can call on almost three decades of credit experience in helping you draw up Risk Management guidelines. These can help your credit department in researching new customers, working with the sales force, and writing credit contracts. For example, see our recommended wording for the "Terms and Conditions of Credit Sales" in the Sept. 30, 1995 issue of "Szabo Collective Wisdom." If you don't have your copy, ask us for one.

It's hard to imagine a collection service that does this much to make collections unnecessary. But we know it's good business. ♦

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