collective szabo wisdom®

SZABO ASSOCIATES, INC. VOLUME 19, ISSUE 4, DECEMBER 31, 2004

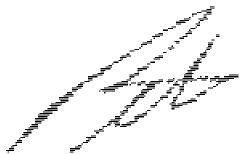
Dear Friends:

Having entered our 34th year, we continue to be blessed as the only "pure play" in the media and entertainment industry. This past year, as our client base grew, we also grew our efforts to anticipate and meet the changing needs of our clientele.

To that end, we have recently completed and implemented a re-engineering, which we initiated back in May. Everyone at Szabo enthusiastically embraced the challenge and took ownership in developing our standards and goals. Our new mission statement— "keeping what we've got, keeping what we get"—reflects our commitment to continue to provide the very best service to all our customers.

To all our friends, old and new, we wish you a happy and prosperous New Year, and we look forward to serving you in 2005!

Best wishes,



Pete Szabo, President
Szabo Associates, Inc.

Know Your Preference Defenses!

Szabo Associates would like to thank C. David Butler for his generous contribution to this article. A former U.S. Trustee overseeing bankruptcy courts, Mr. Butler is a bankruptcy specialist associated with Shapiro Fussell of Atlanta, Georgia.

Hallelujah. You finally got that check that you never expected to get on that long-overdue account! But wait. Before you have time to congratulate your hard-working staff, you find out that the customer has filed for bankruptcy. And then comes the final insult—a letter from the bankruptcy trustee demanding the payment back! After your initial outrage subsides, you have a decision to make. "Do I comply with the demand, do I try to settle for a percentage of the debt, or do I 'go for broke' and try to retain the entire payment?"

Do not send the money back—at least not until you examine the details of the invoice and corresponding payment and explore your preference defenses! The trustee most likely has sent demand letters to all creditors who received a check during the preference period. In fact, many lawyers even file suit without sending a demand letter, and many do not even investigate the merits of their suits. This "scattershot" approach—shooting broadly and waiting to see what hits—yields a windfall of payments from creditors who are intimidated by the demand, unsure of their ability to fight back, or unwilling to invest time and money in the effort.

Like a good general, the wise credit manager fights the battle on multiple fronts. Your first line of attack is to determine whether the trustee can prove each element of his voidable preference claim if challenged in court. Often he cannot. If he can, your second line of attack is to prove any one of the defenses provided to you by the Bankruptcy Code.

The Essential Elements

The initial burden of establishing that a payment is a preference belongs to the trustee. By law, Section 547(b) of the Bankruptcy Code, the trustee cannot establish a preference unless all of the following five elements are met:

1) The payment was made on or within 90 days before the date of the Bankruptcy Petition (or between 90 days and one year before the filing of the petition if the creditor at the time of the transfer was an "insider." The date of the "transfer" is the day on which the check cleared the debtor's bank, not when the creditor received it (a good reason to not delay depositing checks from weakening customers)!

2) The payment was made to or for the benefit of the creditor. This relatively straightforward element can become complicated when a payment is made on a debt that is guaranteed. If the guarantor is a partner, officer, or relative of the customer, payments made by this "insider" are subject to an expanded one-year "reach back" period during which the bankruptcy trustee may sue to recover voidable preference payments. Almost every guaranty, by state law, gives the guarantor a right of recovery against the debtor for payments the guarantor made on its behalf. Therefore, if the customer makes a payment,

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does it not also benefit the guarantor? Has the trustee also sued the guarantor? Should you ask that the guarantor be added to the suit to share your pain?

3) The payment was for or on an account for an antecedent debt owed by the customer before the payment was made. "Antecedent debt" is not defined by the code. In order to be antecedent, it must have been incurred before the transfer or payment from the debtor.

If a debtor and creditor simply swap goods or services, there is no antecedent debt unless the debtor delays delivering its side of the bargain. Since the reach back period is ordinarily 90 days on accounts that are not guaranteed, good preference lawyers will not file suit unless the creditor received payment for an invoice aged 60 days or more. Creditors should not, however, count on that rule of thumb.

4) The payment was made while the customer was insolvent. A balance sheet is used to determine insolvency. If debts are greater than assets, at fair valuation, the customer is insolvent. The Bankruptcy Code provides that "the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." Of the five elements that establish a preference, this is the only one that shifts the burden to the creditor to prove otherwise.

The burden reverts back to the trustee if the transfer occurs more than 90 days before the filing. (Remember that the reach back period for "insider" transfers is one year!) In these cases, therefore, the onus is on the trustee to prove insolvency at the time of the preferential payment in order to prevail in court.

5) Finally, the payment must have enabled the creditor to receive more than it would receive under a Chapter 7 liquidation of the customer's bankruptcy estate. Notwithstanding the existence of the four elements above, a creditor who receives a payment within the prohibitive period does not have to return it if the same amount or more would be received on the creditor's proof of claim if the case were a Chapter 7. This makes sense. Why should the creditor return to the trustee the partial payment, which is about equal to all it would receive in the ensuing bankruptcy? To do so would essentially be "recycling" the dollars to the trustee from the creditor and back again to the creditor! This rule, therefore, requires the trustee to project and prove the likely bankruptcy distributions that would occur in the bankruptcy case if the debtor were liquidated under Chapter 7. If the projected dividend to the creditor under attack proves to be the same as or less than the partial payment, then the creditor really benefited over other creditors by taking that payment and the trustee wins.

The Preference Defenses

Okay, so it looks like the payment you received from the debtor meets the above criteria for a preferential transfer and the trustee can prove it. Now it's time to explore defenses, and here the burden of proof falls upon you, the creditor. The Bankruptcy Code describes defenses to a claim for the recovery of an avoidable preferential transfer, and a creditor needs to prove only one of the defenses to successfully defeat that claim.

1) Ordinary Course of Business. That the payment was made in the ordinary course of dealings is one of the most frequently raised defenses. To successfully defend a payment with this defense, the creditor must show, first of all, that the debt paid was incurred in the ordinary course of business or financial affairs between the creditor and debtor. The creditor must also show that the payment itself was an ordinary one made by the debtor to the creditor. This is not too difficult, since all the records to prove your assertion reside with you.

Be aware, however, that a "subjective test" requires that the specific relationship between the creditor and debtor be thoroughly examined. Are there differences between collection efforts before and during the preference period? Were the average times between invoice dates and payment the same before and during the preference period? The payment need not have been received in accordance with documented terms of payment to successfully argue this defense. If, before and during the preference period, payment was consistently between 45 and 50 days and there were no changes in the collection efforts, you have passed the subjective test.

Beyond this, the creditor must show that the payment was made according to ordinary business terms in accordance with industry norms. The "objective test" prescribed by the Code requires the creditor to provide evidence of the range of terms considered normal in the industry.

Perhaps, however, you have had a long-term relationship with a customer who has fallen on tough times, so you modify its trade terms in exchange for new business. Such a case went before the courts, with an encouraging outcome. The debtor, a long-time advertiser on the creditor's radio stations, consistently paid invoices between 90 and 120 days. Other advertisers usually paid between 60 and 90 days. Although the debtor's payment terms were 30 days, the creditor agreed to change the troubled debtor's terms to 90 days, and the debtor began remitting post-dated checks. The debtor subsequently filed Chapter 7, and the trustee demanded the return of payments within 90 days of the filing. The court held that the creditor was allowed some latitude with regard to the industry standard because of the long-standing relationship with the debtor, and that the timing and method of payment were within the "sliding scale" window of

industry standards. The court cited language in the Bankruptcy Code which states, "[T]he more cemented, as measured by its duration, the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain within the safe harbor of section 547 (c) (2)." For once, a creditor's kindness was rewarded in bankruptcy litigation! The decision works to keep troubled businesses open, hopefully leading to a return to solvency.

2) Subsequent New Value. This defense usually applies where the debtor has an open account with the creditor. The creditor receives a voidable payment for which there is no defense, but thereafter grants additional unsecured credit to the debtor prior to the bankruptcy filing. This "subsequent new value" allows the creditor to reduce or eliminate the claimed preference to the extent the additional credit remains unpaid at the time of bankruptcy.

The purpose of the rule is to encourage extension of credit to troubled debtors, promote equality among creditors, and reward creditors that are willing to enhance the estate during the preference period. Note that under this rule, only amounts invoiced <u>after</u> the preference payment and remaining unpaid <u>before</u> the bankruptcy filing will be subtracted from the amount due back to the estate. Advances made after bankruptcy filing and remaining unpaid are not subsequent new value and so may not be applied to offset preferential transfers prior to bankruptcy. Such advances, however, will likely give rise to a priority claim above unsecured creditors listed in the debtor's schedules.

And what if the subsequent new value is itself avoidable because it has been paid? May it nevertheless be deployed to insulate the prior preference? The emerging trend supports this argument as one consistent with the language of the statute; however, many courts continue to require that the new value remain unpaid.

3) Exchange for New Value. This defense generally applies to payments that are COD, CIA, or CWO (cash with order). Contemporaneous exchange of equal value will not generally be considered an antecedent debt.

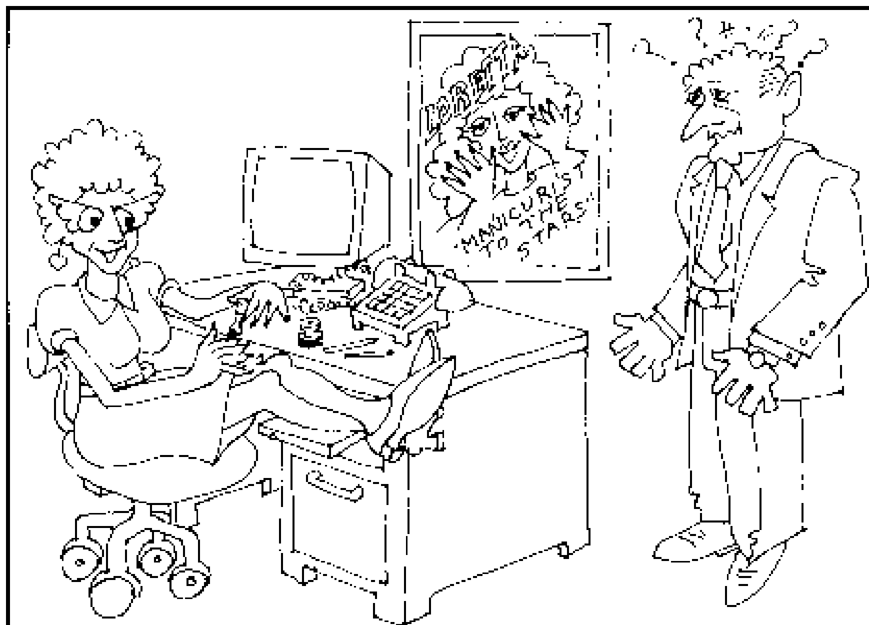
To successfully employ this defense, the creditor must prove that the value given to the creditor (payment) equals the value the debtor received, the debtor and creditor both intended the transfer to be contemporaneous, the exchange was contemporaneous, and a measurable "new value" was provided the debtor.

Perhaps you and the debtor negotiated, prior to the bankruptcy filing, an arrangement whereby the debtor pays cash-in-advance for future services while past due amounts are still owed. In this case, there is neither a credit extension (subsequent new value) nor contemporaneous exchange since it is applicable to future services. The Code does not provide a defense for allowing a debtor to a work out on old debt in exchange for new credit terms.

4) Solvency. This defense almost always requires the creditor to prove, with admissible financial evidence, that the debtor was not insolvent during the preference period. Although this defense carries a significant burden, requiring review of the debtor's books and records and the establishment of the values of diverse assets at a previous point in time, its challenges are not insurmountable.

In Chapter 11 cases, debtors must file periodic financial statements early on. These detailed reports may provide a basis for an accountant and an evaluation witness to work backward only a few weeks or months to show a brighter financial picture than the one claimed by the trustee. Additionally, debtors are usually optimistic about property values and state them accordingly in the schedules of assets required to be filed at the beginning of the case.

An expert witness is usually required to establish this defense. We can wonder just how many preference claims are abandoned because the books are missing or because there is no money to hire an expert!



"SOLVENT, SHMOLVENT. MY FRIEND LORETTA IS THE CEO'S MANICURIST, AND SHE SAYS, 'WHEN A BIG GUY'S NAILS ARE BITTEN DOWN TO THE QUICK, HIS COMPANY IS AS GOOD AS GONE!'"

What to Do

You have just received the dismaying news that the trustee

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wants your "preferential payment" back. What do you do now?

1) Determine if your payment meets the five elements for establishing a preference claim, and that the trustee can prove that it does. If it does not, consider writing a letter to the trustee pointing out his problem. Include the business records that demonstrate the absence of the element. If your letter is ignored, you are sued, and the case is subsequently dismissed, consider having your attorney ask for the trustee to pay your legal fees. If the payment does meet the five elements, consider defenses provided by the Code.
2) Examine the debtor's payment records. As the ordinary course of <u>its</u> business, perhaps the debtor pays at 45-60 days, regardless of the terms of the contract.
3) If the filing is Chapter 11, call your contact at the company. Ask that the claim not be pursued if a continuing business relationship is contemplated.
4) Call the debtor and simply ask, "Were you solvent during the 90-day period prior to filing?" If the answer is "yes," seek to engage the debtor's cooperation and assistance in developing a solvency defense.
5) Consider employing an "expert witness" to review books and documents, and to get an opinion of asset values and the actual level of unsecured debt.
6) If you determine that you have no real defenses to the preference claim, try to settle the case for less than the full amount of the debt, perhaps 50%.
7) Where it exists, take advantage of Electronic Case Filing. The applicable Web site is **http://pacer.psc.uscourts.gov**. Electronic Case Filing offers a wealth of information to creditors by allowing them to peer electronically into the bankruptcy case. Schedules of liabilities and assets may show that the debtor might arguably have been solvent prior to filing. Since values of assets may have been overestimated, you may have a basis for a solvency defense. Settlement orders on other preference cases will give you an idea of what percentage you can expect if you settle. For example, the bankruptcy judge may have approved a blanket "75% settlement authority" to the trustee. You can also find the names of others who have been sued as well as the settlement range. Reports indicating involvement of CPAs and other experts may point toward possible proof solutions, such as the reasonableness of value assertions.

The policy basis of the Bankruptcy Code's preference provisions is to encourage creditors to work out reasonable terms with their delinquent customers. The alternative, to make overreaching demands, could tip the debtor into bankruptcy and result in preference payments that must be returned. Additionally, the provisions work to restrain debtors from gracing friends, family, and guarantors of their choosing with preferential payments and transfers. Whether or not preference law actually fulfills its historical objective to promote a fair distribution among creditors will remain the subject of debate. Nevertheless, as a credit manager, you—and your company—have much to gain by knowing how bankruptcy courts, trustees, and attorneys operate and by taking full advantage of the defenses available to you under the current law. ♦

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