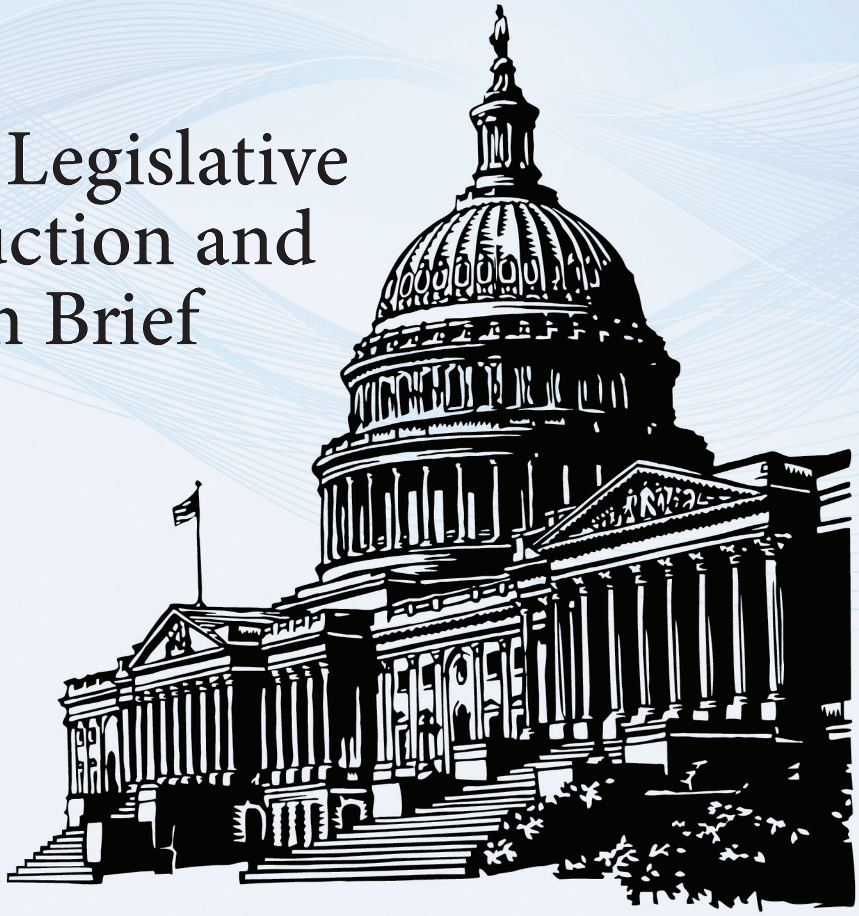
NACM Legislative Introduction and Position Brief 2018



The financial panic of 1893 created a disastrous depression and subsequent severe deflation, both of which stunned businesses. The chemistry of credit was not understood and commercial failures reached record numbers. So serious was the problem that a "Congress of Credit, Collections and Failures" was held as part of the 1893 Great Exposition in Chicago. That meeting, in turn, led to further exploration of the ways that credit practitioners could help each other.

In June of 1896, 82 delegates from several local credit groups met in Toledo to endorse a national movement, creating what is now the National Association of Credit Management. Membership has grown from 600 at the end of 1896, to more than 13,000 today, making NACM one of the oldest and the largest business credit organizations in the United States.

NACM is committed to enhancing, promoting and protecting the many credit management interests of the commercial credit grantor. NACM represents business credit grantors in all industries, including manufacturing, wholesaling, service industries and financial institutions. NACM is a member-owned association and exists solely to serve and support its members.

The purposes and objectives of NACM are to:

- promote honesty and integrity in credit transactions;
- assure equitable laws for sound credit practices;
- foster and facilitate the exchange of credit information;
- encourage efficient service in the collection of accounts;
- provide credit education through colleges, universities, home study courses, NACM and NACM Affiliates;
- promote and expedite sound credit administration in international trade;
- foster and encourage research in the field of credit;
- disseminate useful and instructive information and ideas with respect to credit management techniques and policies;
- provide facilities for the investigation and prevention of fraud; and
- perform and encourage such other functions as the advancement and protection of business credit may require.

Business credit is an integral part of the American economy. The business credit executive—the NACM member—is an essential participant in our free enterprise system. Virtually every business transaction that concerns another business involves credit. Business credit is the single largest source of business financing by volume, even exceeding bank loans. Without business credit, America's economic system, as we know it, would not exist.

Congress has acknowledged many times that federal regulation of the credit reporting process must tackle a number of issues critical to businesses. Ultimately, NACM continues to note that anything that interferes with the free and complete ability of the business credit grantor to make a sound, accurate and equitable credit decision is an impediment to the commerce of this country.

Bankruptcy Reform

As the largest organization of unsecured trade credit grantors in the world, NACM is vitally concerned about the effects that bankruptcy law and practices have on the U.S. economy. To this end, NACM has fought for bankruptcy reform laws that accurately reflect the needed balance between creditors and debtors. NACM believes five areas need immediate attention for the good of business-to-business credit granting and the fate of domestic economic growth: filing venue, preferences, Section 503(b)(9), executory contracts and reclamation.

Filing Venue (Section 1408)

A new bankruptcy bill introduced into the U.S. Senate would curb "forum shopping" in Chapter 11 cases by tightening the wide range of allowable bankruptcy venue options currently available. These court venue options, including a place of incorporation, principal place of business and assets or where an affiliate has filed a case under Chapter 11, has led to an increase in companies filing outside their home states or their principal place of business, concentrating cases into a few districts like Delaware and New York, the bill's text states.

NACM is among a group of associations that support the bill, including the Commercial Law League. "NACM's members have for years consistently raised concerns about the venue issue and asserted that where a case is filed can significantly impact its outcome," said NACM National Chairman Kenny Wine, CCE. "Selecting a venue outside of the debtor's primary location increases the cost of participation by the debtor, adding travel and lodging expenses to the case—costs many American small businesses can ill afford, especially when a key customer has not paid them," he said. "We believe that by requiring the debtor to file in the jurisdiction of its primary place of business or its principle assets, the bankruptcy process will be fairer for all participants."

The Bankruptcy Venue Reform Act of 2018 was introduced by Senators John Cornyn (R-TX) and Elizabeth Warren (D-MA) Jan. 8. The bill would "… ensure corporations file for bankruptcy in districts that allow small businesses, employees, retirees, creditors and other stakeholders to fully participate in cases that will have tremendous impacts on their lives," the Senators said in a joint statement.

"Closing the loophole that allows corporations to 'forum shop' for districts sympathetic to their interests will strengthen the integrity of the bankruptcy system and build public confidence," Cornyn said.

Warren said: "I'm glad to work with Senator Cornyn to prevent big companies from cherry-picking courts that they think will rule in their favor and to crack down on this corporate abuse of our nation's bankruptcy laws."

Delaware lawmakers are not pleased with the bill and responded in their own joint statement. "Denying American businesses the ability to file for bankruptcy in the courts of their choice would not only hurt Delaware's economy but also hurt businesses of all sizes and the national economy as a whole," said Delaware Governor John Carney and Delaware's Congressional Delegation. "Experienced bankruptcy judges are critical to ensuring that companies can restructure in a way that saves jobs and preserves value."

The bill would restrict the venue for Chapter 11 cases to a company's "principal place of business," which is defined in the bill as:

- The place in which the domicile or principal assets of an individual who is the subject of the case have been located for the 180 days immediately preceding the case's commencement;
- The place in which the principal assets or place of business of a person or entity that's the subject of the case have been located for the 180 days immediately preceding the case's commencement;
- Or, the place in which there is already pending a Chapter 11 case concerning an affiliate that directly or indirectly owns, controls, is the general partner or holds 50% or more of the outstanding voting securities of the person or entity that is the subject of the later filed case if the case was properly filed in the district.

Preferences (Section 547)

Section 547 of the Bankruptcy Code requires that all payments made by a debtor to creditors within 90 days of a bankruptcy filing must be returned to the debtor's estate, unless the creditor can prove that the payment was made in the "ordinary course of business," that "new value" was given or that the transaction was a contemporaneous exchange for new value. The fundamental premise of this section of the Code is to prevent any one creditor from receiving favorable treatment over other creditors.

Trustee Due Diligence

Typically, the Trustee for the debtor's estate, or more recently, the liquidating trust under a Chapter 11 plan will issue demands to creditors who received a payment within 90 days of the bankruptcy filing. It is common for the trustee, or the firm the trustee hires, to disregard existing defenses and send out blanket demands or complaints to every creditor who received payments within this 90-day window. The trustee often does little or no prior investigation other than to review the debtor's check register. It is rarely cost-effective for the creditor to contest the action, causing most creditors to enter into a negotiated settlement rather than incur the legal costs of defending the preference action. Making matters worse, there is no requirement that any funds returned to the debtor's estate through preference recoveries are ever dedicated to paying the claims of the unsecured class of creditors—more than 90% of preference recoveries do nothing more than fund recovery activities.

These costly issues will not stop unless the Code is modified. Current law places the burden on the creditor to prove that a payment is not a preference. The current Code offers no repercussions for trustees continuing to engage in this activity—even if the payments to the creditor are legitimate, as is often the case. As such, trade creditors routinely face a double jeopardy: They lose funds due to the bankruptcy and are forced to repay funds already collected. This reality has put many small companies out of business. Other credit grantors have been forced to adopt more rigid credit policies, making them less likely to continue offering credit terms that would help customers who do show signs of distress. NACM believes imposing a due diligence obligation on trustees would assure that blanket demands based on the 90-day clock and check register will stop.

Suggested Wording:
It is necessary for a definition of "due diligence" to be inserted in 547(a) as follows:

Subsection (a) of Section 547 of the Bankruptcy Code (11 U.S.C. §547) is amended by adding the following paragraph:

(5) "due diligence" means a determination by the trustee that there are reasonable grounds to believe, in good faith, that a plausible claim for avoidance exists after taking into account the known or reasonably ascertainable defenses under 547(c) and should include a "new value" analysis for the purposes of Section 547(c)(1) and Section 547(c)(4) and an ordinary course of business analysis for the purposes of Section 547(c)(2).

Subsection (b) of Section 547 of the Bankruptcy Code (11 U.S.C. §547) is amended as follows:

(b) Except as provided in subsections (c) and (i) of this section, and after conducting its due diligence, the trustee may avoid any transfer of an interest of the debtor in property—
  (1) to or for the benefit of a creditor;
  (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
  (3) made while the debtor was insolvent;
  (4) made—
    (A) on or within 90 days before the date of the filing of the petition; or
    (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider, and;
  (5) that enables such creditor to receive more than such creditor would receive if—
    (A) the case was a case under Chapter 7 of this title;
    (B) the transfer had not been made; and
    (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Ordinary Course of Business

The ordinary course of business defense contained in Section 547(c)(2) was created to encourage creditors to continue doing business with their financially distressed customers. However, the ordinary course of business defense is not working as intended because it is very difficult and costly to prove and its application is almost impossible to predict because of conflicting court rulings in different jurisdictions. As a result, creditors, who should benefit from the protections afforded by the ordinary course of business defense, are forced to settle due to the costs associated with proving the defense.

Suggested Wording:
Subsection (c)(2) of Section 547 of the Bankruptcy Code (11 U.S.C. §547) is amended by adding the following paragraph:

(C) For purposes of this subsection, all payments made to a trade creditor that is not an insider of the debtor on or within 90 days before the filing of the petition are presumed to have been made in the ordinary course of business or financial affairs of the debtor and the transferee.

Creating a rebuttable presumption that all payments by a debtor to a non-insider creditor satisfy the subjective part of the ordinary course of business defense would make it easier to prove the defense. It would also further the purpose of preference law, which was to encourage creditors to continue doing business with their financially distressed customers and discourage creditors from racing to the courthouse to collect their claims.

Netting Concept to Replace New Value Defense

The new value defense contained in Bankruptcy Code Section 547(c)(4) has also produced expensive litigation and conflicting results. As a result, the new value defense is frequently not applied consistently and uniformly across jurisdictions or within courts in the same jurisdiction.

Suggested Wording:
Subsection (c)(4) of the Bankruptcy Code (11 U.S.C. §547) is amended by replacing the current language with the following:

(c) The trustee may not avoid under this section a transfer—

  (4) to or for the benefit of a creditor to the extent that during the 90 days before the date of the filing of the petition, the aggregate amount of all such transfers exceeds the aggregate amount of new value such creditor gave to or for the benefit of the debtor that is not paid by otherwise unavoidable transfer by the debtor to or for the benefit of such creditor subsequent to the filing of the petition and not secured by an otherwise unavoidable security interest.

These changes simplify the new value and ordinary course of business defenses and will help avoid much of the unnecessary litigation that has been prompted by issues concerning these defenses. The changes will also encourage creditors to continue extending credit to a financially troubled company, replenish the debtor's bankruptcy estate with new goods and services provided on credit and promote equality of treatment among similarly situated creditors. All are policies that Congress had intended to further when it created the preference statute.

Proposed changes will help minimize the conflicts of interest of firms hired by the trustee, which earn/are paid a percentage of what they collect, only incentivizing attempts to make requests without justifiable defenses. Adding due diligence requirements will compel the trustee to carefully examine any payment made to a creditor and the circumstances surrounding that payment before issuing a blanket preference recovery demand ("emptying the register"). This change would more thoughtfully restore the balance between debtor and creditor rights.

Administrative Priority Claims (Section 503(b)(9))

The current Bankruptcy Code gives business creditors who supported the debtor by supplying it with goods in the 20-day period before the filing date an advantage in recovering the value of their shipments by making the claim an administrative priority one.

Suppliers' Rights

The wording of the Code only addresses actual receipt of goods received in the 20-day window. Frequently in the period leading up to a bankruptcy filing, the debtor will have reduced its headcount in favor of hiring temporary workers, thereby eliminating the cost of benefits and transferring the obligation of employment taxes to the temporary help agency. Likewise, many service providers support the debtor in the final 20 days by supplying services on credit terms that go directly into its product or into the operation of the organization. These trade creditors should not be excluded from having an administrative claim for the work performed in the 20 days prior to the filing. The Code should be changed to require immediate payment for goods and services delivered within 20 days prior to the filing in order to encourage creditors to continue extending credit while the company is in financial distress prior to the bankruptcy filing. The definition of services should exclude claims of lessors and utilities, since these creditors already enjoy existing protections and remedies under other sections of the Bankruptcy Code.

Timing of Payment

The Code fails to define the process for payment of administrative priority claims, sometimes resulting in payments being delayed until a reorganization plan is confirmed despite the fact that other administrative priority claims are being paid throughout the case. For example, secured lenders who had a lien on the debtor's entire inventory claim a lien on the inventory shipped in this 20-day period thereby taking a priority position over unsecured business creditors. Shipments in the 20 days preceding the bankruptcy do little more than support the secured lender on the backs of the trade creditors.

As other administrative expenses are paid throughout the case, the administrative priority trade claims should likewise be paid when they become due. Suppliers of services used in the actual production and distribution of the product or in the ordinary operation of the debtor's business should receive the same treatment as suppliers of goods. During at least 45 days preceding a bankruptcy filing, the majority of debtors filing Chapter 11 are, or should be, fully aware that they are insolvent. Nonetheless, these debtors continue to acquire goods and services on credit terms all for the benefit of their secured lenders whose collateral position improves as a result. These debtors are at the same time negotiating Chapter 11 financing arrangements with their lenders that grant the lenders first priority security interests in all of the debtors' assets. Clearly, there are instances in which debtors are accepting these goods and services on credit terms under false pretenses. Trade creditors would not have extended credit during this time had they known of their customer's insolvency or planned bankruptcy filing. Adequate remedy must be provided to trade creditors.

Drop Shipment

There has also been uncertainty and significant litigation over whether trade creditors who engage in the practice of "drop shipment" are entitled to priority status under Section 503(b)(9). In a "drop shipment" transaction and at the buyer's instruction, a goods seller ships goods to a third party (such as the buyer's customer or a third-party processor). Many debtors have argued against, and some courts have denied, priority status under Section 503(b)(9) because the debtor did not obtain physical possession of the goods in a "drop shipment" transaction. This should be rejected as there is no basis for the argument. As a result, the definition of "receipt" in Section 503(b)(9) should be changed to include drop shipment transactions. Changing the definition is supported by many credit industry experts and veteran attorneys alike.

Asserting Priority Claims

There is also a great deal of confusion about the manner in which goods sellers can assert their Section 503(b)(9) priority claims. Section 503(b) states that administrative expense claims, which include Section 503(b)(9) priority claims, are allowed "after notice and a hearing." This suggests that a creditor asserting a Section 503(b)(9) priority claim must go through the expense of retaining an attorney to file a motion for relief with the bankruptcy court. This is unnecessarily expensive both for the creditor and the debtor.

Suggested Wording:
The Administrative Claims section of the Bankruptcy Code (11U.S.C. §503(b)(9) is amended by replacing the current language with the following language:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under Section 502(f) of this title, including—

  (9) the value of any goods and/or services received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business, which claim shall be payable by the debtor immediately upon the allowance thereof. "Services" shall not include claims asserted by lessors and utilities. "Receipt" shall occur upon either the debtor's receipt of the goods or receipt of goods by a third party pursuant to the debtor's instruction. A creditor shall be permitted to include a claim arising under Section 503(b)(9) as part of its proof of claim filed under Section 501(a) of this title.

Executory Contracts (Section 365)

In situations involving long-term contracts and/or supply orders, debtors are provided with a period to review each executory contract and either reject or accept it and pay any amount of prepetition debt owed on the contract. As this can take several months, it can be a financial burden to require trade creditors to support the debtor's reorganization and rehabilitation by supplying more goods and services needed in the normal operation of its business on credit terms prior to assumption or rejection. Requiring creditors to support debtors during the review period can cause a tremendous cash flow burden to creditors, through no fault of their own.

Trade creditors should not be required to continue to sell to the debtor on credit during this period prior to the debtor's decision to assume or reject their executory contracts. As is currently required, the continued extension of credit piles more debt and risk of loss on trade creditors. If, for any reason, the debtor is unsuccessful in its reorganization attempt and the case is converted to liquidation, those creditors who extended credit during the case will stand behind secured lenders in line and have little, if any, chance of recovering this additional, new loss.

Suggested Wording:
Section 365 of the Bankruptcy Code should be amended to include the following new subsection:

(q) Notwithstanding any provision to the contrary in any executory contract, no creditor shall be obligated to continue to extend trade credit to a debtor subsequent to the commencement of a case under any chapter of this title.

Reclamation (Section 546(c)(1))

The Bankruptcy Code provides trade creditors a remedy on reclamation, a remedy that is closely linked to the protections afforded in Section 503(b)(9). This right was expanded in the 2005 changes to the Code to include goods shipped within 45 days prior to the commencement of a bankruptcy proceeding, rather than the previous 10-day reclamation period. However, cases decided since the 2005 changes have often come down against trade creditor rights. Very frequently, reclamation claims in Chapter 11 cases provide trade creditors little to no protection, even if those goods were shipped within the statutory 45-day period. Despite this fact, the trade creditor community still believes the current state of the reclamation provision is preferable to the one used prior to the 2005 changes, but only due to the presence of Section 503(b)(9), which works as a critical safety net for creditors unable to assert reclamation claims.

Consumer Credit Report Regulation versus Commercial Credit Report Regulation

Historically, lawmakers have recognized and respected the differences between commercial and consumer credit and the important differences in how information is used in both arenas. As defined in the Fair Credit Reporting Act (FCRA), whether a purchase on credit is a consumer or a commercial transaction is determined by the end use of the purchase: if the purchase is for personal, family or household use, it is a consumer transaction. On the other hand, purchases made on credit for business use are generally accepted as commercial transactions.

Although the FCRA does not define the term "commercial transaction" specifically, and only governs commercial transactions when a business relies on a consumer report to make a business credit decision, there are a number of important practical characteristics that illustrate the vast differences between commercial credit transactions and consumer credit transactions. Commercial credit executives must review everything from the customer's application, financial statements, business references, commercial credit reports and beyond. To increase the speed and reliability of this decision, and to increase the quality of commercial credit reports, companies share their accounts receivable information, or historical, factual data about their customers' payment habits, with commercial credit reporting agencies. In turn, trade payment information is one of the components used by the nation's thousands of credit and risk professionals to arrive at an independent decision about whether or not to sell to a business customer on credit. This information helps business creditors determine the willingness and likelihood of a new customer to pay their obligations as they become due and the level of integrity with which they operate, and to assess their character. It is critical to keep this information flowing freely.

Experts have warned Congress that onerous or poorly conceived regulation in this area could result in serious delays in the availability of business credit information. Such delays could cost the economy an annual sales loss exceeding $60 billion. Any restrictions on the free flow of credit information will slow the economy and further place American businesses at a competitive disadvantage. Ultimately, anything that interferes with the free and complete ability of the business credit grantor to make a sound, accurate and equitable credit decision is an impediment to the commerce of this country. Everyone loses—not only the businesses themselves, but also the consumer of the goods and services they provide.

Despite the vast differences between consumer and commercial transactions, many people incorrectly and dangerously blur the line between the two. This presents two issues for the commercial credit community from a regulatory standpoint:

Protecting Information

Information on companies and individuals is now more accessible and more freely exchanged than at any previous point in history. As a result, lawmakers have sought to protect individuals from criminals who would use this openness to their own nefarious ends. NACM fully believes in every American's right to the security of their own financial and personally identifiable information, and wholly supports legislative efforts that seek to guarantee that right. However, NACM urges the federal government and states that any such legislation must be carefully defined and accurately drafted to apply specifically to personal information rather than to the commercial data willingly exchanged between businesses in order to assess creditworthiness. Extending the approach that some state legislators unknowingly tried to take in recent years toward regulating the exchange of consumer information in the same manner as trade credit information would be disastrous for the U.S. economy and must be avoided.

Sources of Negative Commercial Payment Information

In 2013 and 2014, some of the nation's smallest businesses were targeted by marketing companies promising to help improve a business' commercial credit in exchange for a subscription fee, borrowing a tactic that's already in use in the consumer credit arena. In reaction to this deceptive marketing practice, some lawmakers unsuccessfully proposed legislation designed to require disclosure of the identity of a source of negative trade payment information on a commercial credit report should be disclosed. NACM's position is that rescinding a company's right to anonymously share its historical, factual trade payment data would result in a massive chilling effect on businesses' participation therein and, thus, overall credit-granting activity levels. This would badly impair the economy. It would also require businesses to allocate staff, that it often can ill afford, to respond to inquiries, or decide to omit any trade data that could be construed as negative, distorting a potential debtor's true profile. NACM believes that rather than regulating *commercial* credit information, educating small companies about commercial credit and about how it differs from consumer credit would correct the problem being caused by savvy marketers in search of fees. NACM also believes that it is critical for lawmakers to use specific language in legislation to ensure that credit extended for business purposes is not swept into regulations that govern credit extended for personal, family or household use. Failure to do so would fail to address existing problems, notably on the consumer side, while creating significant unintended consequences. To support and educate small businesses and legislators on this topic, NACM created a fact sheet, "Commercial Credit: What Every Company Needs to Know," as a basic yet definitive guide.

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