For Immediate Release

New York Creditors Say They Suffer While Trustees and Attorneys Reap the Benefit of Bankruptcy Preferences

Columbia, MD: Friday, February 4, 2005—David Carere thinks the whole bankruptcy preference process has been turned on its head. “The way preferences work seems counter to everything in our legal system,” said Carere, Vice President, Finance - Credit and Account Settlement, for Rich Products Corporation, a frozen foods manufacturer headquartered in Buffalo with annual sales in excess of $1 billion. “First, the preference code makes an assumption about the debtor and applies it retroactively; then it assumes that the creditor is guilty until he proves himself innocent.”

An arcane section of the Bankruptcy Code related to so-called “preference” payments is causing U.S. business creditors, large and small, to lose money just for doing their jobs—and they’re not happy about it.

How much they lose is difficult to determine because most preference lawsuits are settled out of court and businesses have not separately tracked the staff time and legal expense they incur in fighting these actions. But the problem has grown worse in the last 10 years as the number of business bankruptcies increase.

Under the Code, a business that files for bankruptcy is assumed to have been bankrupt in the 90 days prior to filing. Any payments made to creditors during that period are assumed to be preference payments, because those creditors were “preferred” over others. Those payments can be taken back by the debtor and ostensibly returned to the pool of funds from which all creditors will eventually be paid—unless the creditors who got paid can prove the payments weren’t preferential. It sounds fair, though complicated, but it’s not working that way. Creditors say that most recovered preference payments go to pay trustees and attorneys with little or nothing going to unsecured creditors.

In a landmark study on preference payments conducted by the American Bankruptcy Institute (ABI) in 1997, the following question was asked: “How often are distributions to unsecured creditors in bankruptcy cases increased as a result of recoveries in preference actions?” Seventy-five percent of creditors responded “never or rarely” while only 37.5 percent of bankruptcy practitioners (mostly lawyers, some trustees and accountants) answered “rarely or never.”

“The whole preference system has spun out of control,” said Robin Schauseil, President of the National Association of Credit Management (NACM), one of the oldest and largest organizations in the country representing the grantors of business credit. “These rules are supposed to divide assets fairly and prevent a stampede of worried creditors during a company’s final days, but indiscriminate lawsuits against suppliers have turned the preference law into a cash machine for bankruptcy lawyers and a headache for credit executives.” Credit managers in New York agree.

“When one of our customers goes bankrupt and we’re a creditor, we see the correspondence between the trustee and the bankruptcy judge,” said Michael Tanea, Corporate Credit Manager of Admar Supply Company, Inc. of Rochester. The privately held company with annual sales of $20-$50 million rents and sells heavy equipment. “We see attorneys and others sending in bills for their work at $75-$100 an hour or more, while we sit here waiting to get 10 cents on the dollar.” (Fees vary widely: In New York City, they may be as high as $700-$800 per hour.) Tanea said his company has had two preference actions filed against it in recent years, each for $6,000-$7,000. “It hurts when you find that your customer is using your funds to keep his business going,” said Tanea. “Then he files bankruptcy and you’re out what he owes you. On top of that he wants to take a legitimate payment back.”

James Dentico, Corporate Credit Manager for B&L Wholesale Supply, headquartered in Rochester, agreed. B&L is a privately held company in the building supply business with annual sales around $50 million. “We deal with building contractors and frequently have accounts past due for $20,000 to $40,000.

If they go bankrupt, we're out that money and then we're asked to give back another $10,000 or so they've already paid… You're penalized for being a good collector," he said. Dentico thinks the preference period is too long, and should be reduced from 90 days to 30 days. "The 90-day period causes credit managers to be much more conservative in how they extend credit," he says. "That ultimately has an impact on the businesses requesting goods on credit… and on economic growth."

Another troublesome aspect of the code is that preference lawsuits may be filed in the debtor's jurisdiction instead of the creditor's, which encourages the filing of blanket suits naming everyone who got a payment from the company in the 90 days before it filed for bankruptcy. "In my experience, the trustees and attorneys do very little legwork to find out if any of these payments actually were preferences," said Carere. "Essentially, they open the debtor's check register, count back 90 days and sue anyone who got a check in that period."

Carere says his company is usually defending three or four preference actions at any given time. Cases currently open total well into six digits. Some are settled quickly, others drag on for several years. He estimates that 5 percent of his and a staff member's time is devoted to preference actions.

When a creditor is sued or threatened with a suit, he must review the history of that account and determine the best defense. The law recognizes five exceptions or defenses against preference claims with the most commonly used being "ordinary course of business." This defense requires the creditor to show that the payment in question conformed to the regular pattern of dealings between himself and the debtor. The creditor must also show that the business relationship and credit terms were in line with the range of terms in the applicable industry. If he can establish both of these premises and the payment in question falls within the established pattern, he likely has a solid defense. But in some cases even a minor deviation such as calling the debtor or sending a reminder notice might nullify the "ordinary course" defense. In view of the fact that the ordinary course of business defense is subjective, and the subject of substantial litigation and varying court decisions, each case must be looked at on its own facts and generalizations are not necessarily reliable. There are no hard and fast rules as to whether any pattern applies or are subject to the defense.

Preparing a defense requires time and usually consultation with an attorney. Defending the suit in court is even more costly. If the suit has been filed in a distant jurisdiction, it may involve travel and hiring a local attorney. These costs can add up fast, putting pressure on the creditor to settle rather than fight. That is particularly true in the case of small businesses that usually don't have the staff, the money or the expertise to wage an expensive battle they may end up losing. Is it any wonder then that most preference lawsuits are settled out of court?

In an online survey conducted among its members recently, NACM asked about settling preference suits. Sixty-nine percent of those answering said they had accepted a settlement in a preference action even though they thought the claim was defensible. Over 90 percent said the decision to settle was based on the cost to defend the claim versus the amount of the claim. And 86 percent agreed that indiscriminate lawsuits against creditors had turned the preference rule into a profit center for trustees and some attorneys.

Schauseil says that the specter of possible preference actions is reshaping business credit policy, a dangerous situation since business credit is the single largest source of business financing in the United States.

John C. Newman, Credit Manager for McLean-Thomas, Inc., a privately held wholesale distributor of building materials serving the Buffalo area, says it has had an effect on his company. "We are very diligent in checking out our customers," Newman said. "We try to structure our deals in such a way that we can avoid or defend preference claims. We get a firm handle on the prevailing business norms and make sure we're in line. If necessary, we only ship orders C.O.D." Newman said he has had preference actions filed against his company and was currently fighting one for $1,500.

What can be done to stop preference abuses? The credit managers themselves have suggestions on how to reform the preference law. First, they would shift the burden of proof from the creditor to the debtor. They believe this would stop most frivolous lawsuits. They also think that any recovered preference payments should go only to help repay creditors. "Find another way to compensate trustees and attorneys," Tanea said. Carere thinks the debtor should pay the creditor's legal costs if the creditor wins a preference lawsuit. And he wants to see averages used for payment amounts and schedules in the "ordinary course of business" defense. Most agree that preference suits should be filed in the creditor's jurisdiction, and they would like to see the preference period shortened from 90 to 30 days.

Whether these or any changes will be made to Section 547 of the Bankruptcy Code anytime soon is anyone's guess. NACM has fought for bankruptcy reform, including changes in the preference code for many years. The organization worked with the National Bankruptcy Review Commission (NBRC), which recommended a comprehensive overhaul of the bankruptcy code to Congress in 1997. Since then a number of bills have been before Congress but none have been enacted. NACM is hoping that the situation is going to change, since the Bankruptcy Reform Act was just reintroduced by Senator Grassley (R-IA).

"Something's got to happen," said Schauseil. "The whole purpose of the preference law has been subverted. Neither debtors nor creditors are winning this one."

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The National Association of Credit Management (NACM), headquartered in Columbia, Maryland, supports more than 25,000 business credit and financial professionals worldwide with premier industry services, tools and information. NACM and its network of Affiliated Associations are the leading resource for credit and financial management information and education, delivering products and services which improve the management of business credit and accounts receivable. NACM's collective voice has influenced legislative results concerning commercial business and trade credit to our nation's policy makers for more than 100 years, and continues to play an active part in legislative issues pertaining to business credit and corporate bankruptcy.

Media Contact: Norma Heim
Phone: 410-740-5560
E-mail: normah@nacm.org