



The National Association
of Credit Management



Presents:

**Pinpoint Methods to Reduce
Exposure of Canadian Firms
to U.S. Bankruptcy Preference Actions:
The Ultimate Cost
of Doing Business in the U.S.**

Pinpoint Methods to Reduce Exposure of Canadian Firms to U.S. Bankruptcy Preference Actions: The Ultimate Cost of Doing Business in the U.S.

The information provided in this presentation is offered purely for informational purposes. It is not, and is not intended to be, legal advice, which should only be obtained from a qualified attorney or legal counsel.

Credit Getting Ugly?



Step 1: What steps can be taken to reduce or eliminate the potential for bankruptcy actions ever happening again to your firm?

- 1) Completely eliminate all potential for Bankruptcy: Offer no credit terms and sell only on a cash-in-advance wire transfer basis.
- 2) Ways to reduce the potential for being hit with a preference action:
 - a. Stay alert to the danger signs such as newspaper articles on companies and industries, changes in government regulations related to an industry and continued downturn in the economy
 - b. Join a U.S. industry trade association
 - c. Subscribe to electronic newsletters that cover firms in the industry in the U.S. that you sell to or provide news items on firms in trouble

2. Ways to Reduce the Potential for Being Hit with a Preference

Action: (Cont.)

- d. Secure your sales to the debtor with a standby letter of credit, purchase money security interest filing, a general UCC-1 filing on all assets or a security deposit (for service-oriented work)
- e. Keep your credit terms and the way your customers pay you consistent and in complete compliance with your written credit and collection policies and procedures
- f. Make sure that your contact follow-up with your customers stays consistent with your written credit and collection policies and procedures
- g. Use the Internet and web sites of local newspapers (near your customer's headquarters for those in trouble) to provide you with a head-ups of any changes or bad news related to your customers

2. Ways to Reduce the Potential for Being Hit with a

Preference Action: (Cont.)

- h. Consider any requests/demands by a customer for longer credit terms as a sure sign that a bankruptcy filing is coming
- i. Stay alert and keep your ear close to the ground!

Step 2: Once a potential bankruptcy filing by a debtor is anticipated, what can be done to reduce your firm's exposure?

1. If customer is currently past due immediately place on credit hold or only sell on a C.O.D./Cash in Advance basis until past due balance is eliminated
2. If this is not an option, trade payments even up, for new shipments or services offered
3. See if customer will pay using a P-Card (i.e., purchasing/credit card)
4. If possible, switch the customer to a Promissory Note with set monthly payments and a personal guarantee by the owner(s) (private firm) and sell on a C.O.D. basis for new goods or cash in advance for new services

Step 2: Once a potential bankruptcy filing by a debtor is anticipated, what can be done to reduce your firm's exposure? (Cont.)

5. If possible, push for larger payments/smaller shipments/service orders until previous balance has been greatly reduced, then trade dollars equally for shipments/service orders
6. Push to obtain security such as a standby letter of credit, security deposit, a purchase money security interest or a general UCC filing on all assets

Step 2: Once a potential bankruptcy filing by a debtor is anticipated, what can be done to reduce your firm's exposure? (Cont.)

Special Note:

Items 1, 4, 5 and 6 could be construed as potential proof that a preference existed, but if any of these strategies can be accomplished before the 90 days prior to the filing of a bankruptcy, then they will greatly reduce or eliminate the chances of a preference and leave you with either no or a very reduced claim.

Step 3: Now that your U.S. customer has filed, what actions are needed immediately?

Non-Preference Oriented: (date that the debtor has filed bankruptcy or immediately thereafter)

1. If you sell goods to the debtor, determine if goods are in transit and instruct the freight carrier to return them to your firm
2. If goods have been shipped in the 20 days prior to the filing of the bankruptcy file a reclamation action (an attorney will be needed to file this motion with the bankruptcy court)
3. If your firm is one of the top five to 10 creditors consider petitioning the bankruptcy court to be on the creditors' committee (If you are one of the top 10 creditors, you most likely will have already been contacted and asked if you wish to be on the creditors' committee.)

The
HONEST LAWYER



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England

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Non-Preference Oriented: (date that the debtor has filed
bankruptcy or immediately thereafter) (Cont.)

4. If you have a UCC-1 filing on goods sold to the debtor, check the date when the filing was done and determine if it was prior to 90 days from the bankruptcy filing date
5. If you have a standby letter of credit as security and have included in the letter of credit's body that if bankruptcy is filed the letter of credit payment can be accelerated, then proceed to file for payment of any invoices that are covered by the letter of credit (check to see if the letter of credit was issued prior to 90 days from the bankruptcy filing)

Non-Preference Oriented: (date that the debtor has filed
bankruptcy or immediately thereafter) (Cont.)

6. Determine if you are a “critical vendor” to the debtor (a vendor whose goods or services if immediately stopped would put the debtor out of business); if so, file a motion with the court for a critical vendor status (an attorney will be needed to file this motion with the bankruptcy court)
7. Determine the deadline date for filing a proof of claim and obtain all supporting documents needed (statement of account along with copies of any open invoices, credit memos, etc.) and file your proof of claim in a timely manner

Step 4: What actions need to be addressed and are critical to be done but need not be done on the day bankruptcy is filed?

Preference Oriented:

- 1) **Locate documents needed to deal with a potential preference action including:**
 - a. Copies of all invoices going back to 27 months prior to the bankruptcy filing date reflecting the credit terms that were extended on each invoice
 - b. Copies of all payments made during the 27 months prior to the bankruptcy filing date (copies should include the check stub which shows what was paid and the amount paid, as well as any supporting documents that were attached to the check stub including debit memos, credit memos, correspondence, etc.)

Preference Oriented: (Cont.)

- c. A payment history report that is original (not an Excel spreadsheet) which details the entire payment history with the debtor or at least up to the 27 months prior to the bankruptcy filing date
- d. Copies of all correspondence between your firm and the debtor including letters, emails, computer or file conversation notes, contracts and agreements, promissory notes, security agreements/UCC-1 and any other documents exchanged between the debtor and your firm

Preference Oriented: (Cont.)

- e. Copies of all industry payment records (if your firm is a member of an industry trade group) for the period covering 120 days prior to the bankruptcy filing date
- f. Copies of all adjustments, credit and debit memos during the 27 month prior to the bankruptcy filing date

Preference Oriented: (Cont.)

- g. List what credit terms of sales were extended (including whether a cash discount was offered) during the 27 months prior to the bankruptcy filing and determine when they were offered and if any holiday dating or special seasonal dating was offered. If different credit terms were offered for different products or services, then this also needs to be noted
- h. What SIC (Standard Industrial Classification) code or NAICS (North American Industrial Classification Service) code covers the goods or services that you sold to the debtor

Preference Oriented: (Cont.)

- 2) What do you do with all documents that are needed to defend a preference action?
 - a. Have all documents scanned
 - b. All scanned files should be placed on a CD/DVD with a least three copies of the CD/DVD records made
 - c. One CD/DVD should be provided to your outside attorney so that they will be prepared to address any preference action that is filed against your firm
 - d. One CD/DVD should be placed in the debtor's folder

Preference Oriented: (Cont.)

- 2) What do you do with all documents that are needed to defend a preference action? (Cont.)
 - e. The final CD/DVD should be placed in an off-site safe storage area with all the original scanned documents as a backup to the CD/DVD provided to outside counsel and in the debtor's credit folder
 - f. A note should be recorded in the Debtor's credit folder/computer call records as to the locations of all copies of the CD/DVD and the original records

Step 5: What should you do when you get a preference demand letter?

- 1) If you have not been sued but merely informed that a preference exists:
If a letter is received or your firm is contacted by a law firm or other organization representing the bankrupt estate and they advise that your firm has a preference, then you can either pull your records and build a defense to use to negotiate a final settlement or you can hire an attorney and advise the party to contact them. This typically will occur within two years after the bankruptcy filing date.
 - a. If you build a defense and negotiate a settlement, the only money paid out will be the final settlement amount or nothing if you have a complete defense

1) If you have not been sued but merely informed that a preference exists: (Cont.)

- b. If you hire an attorney you will have to pay their fee for defending you plus any settlement amount that is negotiated. Again, if a complete defense is proven, then the only fee will be that of the attorney's time spent on your firm's defense.

1) If you have not been sued but merely informed that a preference exists: (Cont.)

- c. Hiring an independent firm that can also build your defense and negotiate on your behalf is a third alternative. These firms typically charge a percentage of the savings that they obtain on your behalf. The amount paid to this firm would be based on a percentage of the difference between the preference amount less what was negotiated as a final settlement. Thus, if a preference amount was \$50,000 and your firm settled the action paying nothing, then the firm representing you would be paid a percentage of the \$50,000 savings.

Step 5: Who will your firm need to hire if you are hit with a preference action?

(Cont.)

- 2) If you have been sued and received a copy of the Complaint: This will typically occur within two years after the bankruptcy filing date. Your firm will need to hire a bankruptcy attorney. The fees vary depending on who you hire and the firm that they work for. It is recommended that you hire one that is located in the Bankruptcy District where the filing occurred. This saves the additional cost of hiring a bankruptcy attorney in your area and then being required to hire local counsel if your attorney is not licensed to practice in that area. To save on further costs involved with the preference action you may instruct your attorney to negotiate a final settlement of the suit. With the number of bankruptcies occurring currently and the desire to maximize the returns to the estate, many trustees will push for the hiring of an independent expert witness by the defendant (your firm) in order to get them to settle for a higher amount rather than paying the additional fees of hiring an independent expert witness.

Step 5: Who will your firm need to hire if you are hit with a preference action? (Cont.)

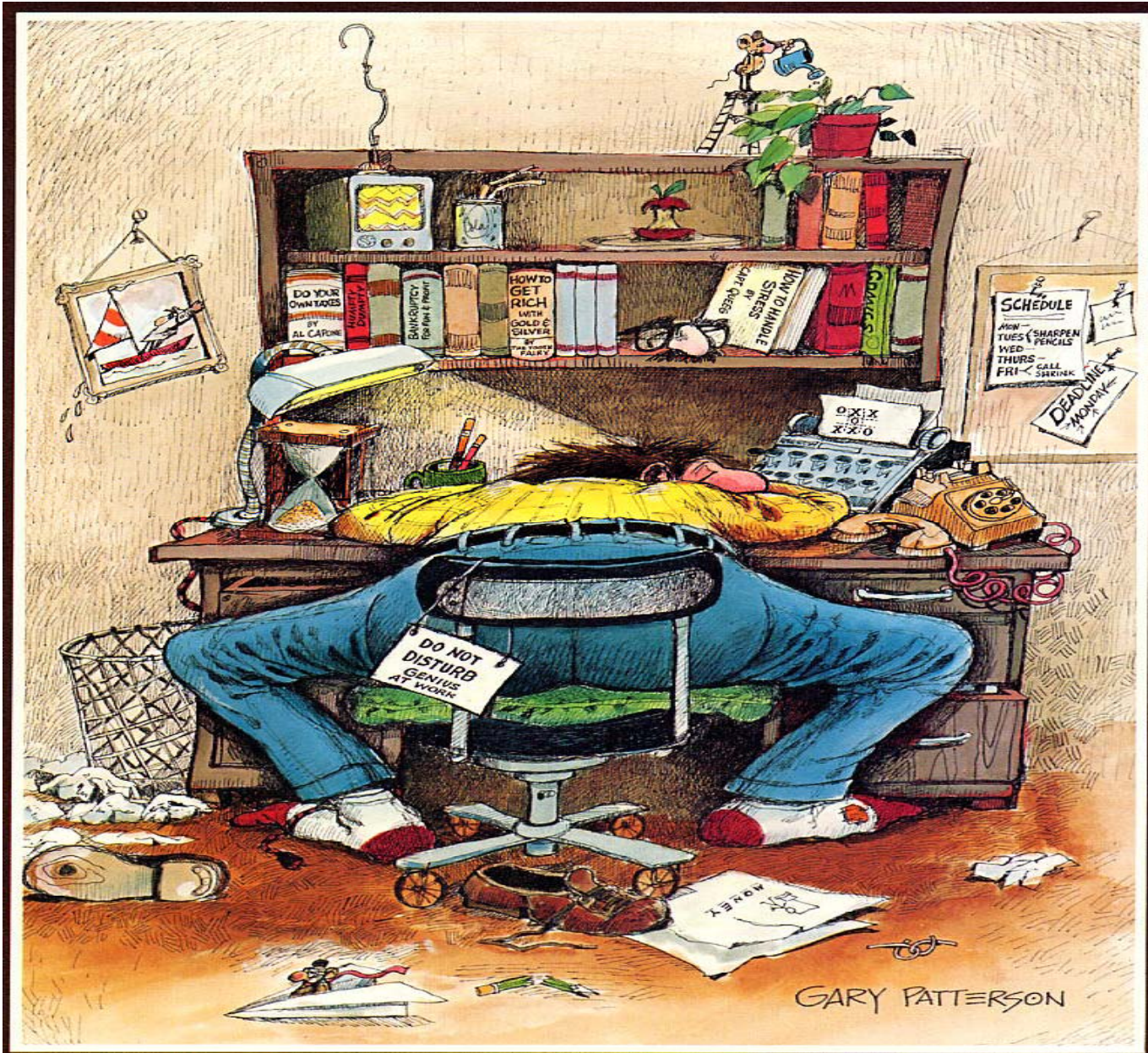
3) If you have been sued and received a copy of the Complaint:

Depending upon the dollar amount of the preference action and the complexity of the case an independent expert witness may need to be hired. Their fee varies depending upon who you hire and where they are located in relation to where the bankruptcy action is filed. These expert witnesses are paid on an hourly fee basis, which is subject to what work they are performing.

Their travel expenses are additional to their hourly fees.



***"Ladies and gentlemen,
is there a bankruptcy attorney on board?"***



Certified Expert Witness at Work!

**Step 5: Who will your firm need to hire if you are hit
with a preference action? (Cont.)**

- 4) Mediation Fees: In some cases, a mediation can be held where your counsel, a representative from your firm who has full authority to settle and an expert witness for each side may appear in front of a mediator to negotiate a final settlement of the preference action. In some Districts the cost of the mediator is split; in others the estate pays the cost.

Step 5: Who will your firm need to hire if you are hit with a preference action? (Cont.)

- 5) Depositions and Court Appearances: Costs incurred here include the court cost and attorney fees if you lose for not only those working on your behalf but also the fees of the other side. If you win then the cost will only be for your side of those attending on your behalf. Those attending include your attorney, your expert witness and any required representatives from your firm who will be testifying.

**Step 5: Who will your firm need to hire if you are hit
with a preference action? (Cont.)**

- 6) Court Decision: Once a decision is rendered by the Court, your firm may be instructed to pay either all or a portion of the preference action, which is in addition to the previously stated fees. Likewise if your firm loses then they can pay the court-decided amount or decide to appeal the decision to a higher court. This will, of course, incur additional legal fees.

Step 6: What is a Bankruptcy preference action?

- 1) **A transfer of the debtor's assets (cash or merchandise) was made:**
 - a. The definition covers every mode of disposing of property whether direct or indirect, absolute or conditional, or voluntary or involuntary
 - b. Virtually any payment, gift or other transfer of assets may fall within the provisions, including any voluntary payment by the debtor of an outstanding unsecured bill or the satisfaction of the same debt through the seizure of assets

Step 6: What is a Bankruptcy preference action? (Cont.)

2) **To or for the benefit of a creditor:**

- a. The transfer must go to the creditor or somehow directly benefit the creditor

Step 6: What is a Bankruptcy preference action? (Cont.)

- 3) **For or on account of an antecedent debt** (a debt made before the filing of a bankruptcy petition):
- a. An antecedent debt is one that was in existence prior to the alleged preferential payment
 - b. The giving of the collateral or the repayment of the loan or trade balance, which was initially to be an unsecured loan or trade balance, constitutes payment on an antecedent debt which may be deemed preferential
 - c. This may be especially true when there was a personal guarantee provided by the largest shareholder of a firm when the debt was initially made

Step 6: What is a Bankruptcy preference action? (Cont.)

- 4) **While the debtor was insolvent:**
 - a. The bankruptcy code creates a rebuttable presumption that the debtor was insolvent for the 90 calendar days preceding the filing of bankruptcy.
 - b. Proving this may be extremely difficult since the debtor's records are often so incoherent that it is difficult to determine the debtor's financial condition immediately preceding bankruptcy
 - c. The proof required would be to show that prior to the filing date the debtor had more assets than liabilities (the balance sheet test)

Step 6: What is a Bankruptcy preference action?

(Cont.)

- 5) Within 90 days of the petition for relief (the period is up to one year if the transfer is to an insider):
 - a. One concern that has been tested in court has been the date that a check is tendered in the debtor's bank. This is the start date for the 90-day window and not the date of the check or the date that it is deposited in your lockbox

Step 6: What is a Bankruptcy preference action? (Cont.)

- 6) **The effect of which is to give the creditor more than the creditor would otherwise receive in a Chapter 7 liquidation:**
- a. Payments of proceeds from the liquidation of collateral subject to a properly perfected security interest are generally not preferential since the creditor would receive as much in a Chapter 7 liquidation.
 - b. In calculating the preferential effect, the potential dividend from the bankruptcy estate as a percentage of claims is compared to a percent of the claim actually received by the transferee.

Step 7: What are the defenses to a bankruptcy preference action?

1) Contemporaneous Exchange

- a. A simultaneous transfer of funds to a creditor at the same time that the goods are delivered is the simplest (e.g., C.O.D. or C.I.A.)
- b. If a check is returned twice and is then replaced by a certified funds, the replacement funds are not considered C.O.D. but two separate transactions

Step 7: What are the defenses to a bankruptcy preference action? (Cont.)

2) New Value

- a. Payment on an old debt in exchange for new goods or services
- b. Payment must be made before the release of new goods or services and must be a related transaction

Step 7: What are the defenses to a bankruptcy preference action? (Cont.)

- 3) Ordinary Course of Business
 - a. The transfer was in payment of a debt incurred by the debtor in the ordinary course of its business or financial affairs and of the transferee's business and financial affairs
 - b. The transfer itself was made in the ordinary course of business of both debtor and creditor
 - c. The transfer was according to ordinary course of business terms

3) Ordinary Course of Business (Cont.)

d. Subjective Prong of the Ordinary Course of Business

Defense: Comparison of the payment history between the parties

e. Objective Prong of the Ordinary Course of Business

Defense: Comparison of the preference period payment history to that of overall industry standards

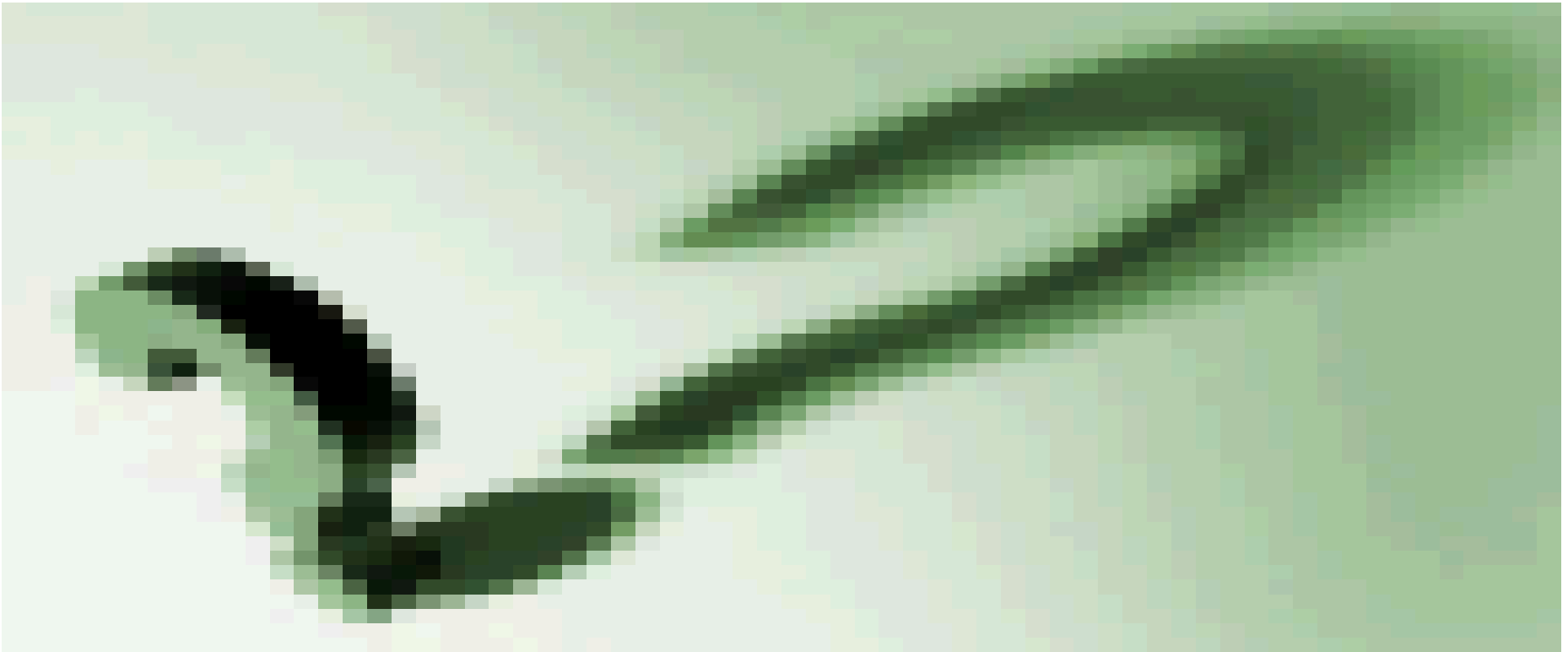
Summary:

- While it is very difficult to maintain complete control and awareness of the status of a customer that is in trouble considering the number of firms filing bankruptcy daily as well as the current state of the U.S. economy, the credit department must always remain the first line of defense for its firm to keep bankruptcy and preference exposures to a minimum. Vigilance and having the right sources of information, as well as having a team both inside and outside of your firm to assist you, can keep your exposure down.
- When faced with a bankruptcy or a preference action, act quickly and decisively as it is rare that you will be allowed a second chance. Never try to deal with these events alone. Know when to ask for assistance both inside and outside of your firm. Always keep your eyes and ears open for the warning signs of bankruptcy.

Summary (Cont.):

- Winning can be the difference of paying a minimal amount or nothing versus paying a very large or the entire amount of the preference plus interest and court costs on top of your legal expenses. Being smart and focused and monitoring your largest customers and their industries, as well as **being consistent in the way you do business with all customers while consistently following your formal written credit and collection policy and procedures manual**, will help you to win the battle with U.S. customer bankruptcies and preference actions.

Questions?



Contact Information

The D & H Credit Services Inc. Mission:

Maximize its clients profitability while minimizing their risks.

A Special Thank You from:

H.A. (Hal) Schaeffer Jr., CCE, CEW, President

D & H Credit Services Inc.

171 Haut-Brion Avenue

Newark, DE 19702

Phone: (302) 832 - 6980

E-mail: halschaeffer@dandhcredit.com

Web Site: www.dandhcredit.com