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Sources for Discovering the Latest Credit and A/R Technology

CRF Survey Results

By Tom Diana

3rd Qtr.

Credit and Accounts Receivable management, like most business functions, are increasingly reliant upon new technology to increase productivity and lower costs. So it's no surprise to learn from a recent CRF Survey that credit professionals are quite proactive when it comes to acquiring information on the latest trends in Credit and A/R technology.

CRF launched this survey in August 2015 to determine the most commonly used sources of information when trying to acquire knowledge about the myriad of offerings. About 400 participants were given six categories of information sources from which they could then choose all that applied. The six categories were:

1. Printed publications (credit, technology, IT, etc.)
2. Credit groups and other credit-related meetings
3. Educational associations such as CRF
4. Their company's IT department
5. Webinars and other online informational offerings from credit practitioners
6. Email and web-based news sources

CRF survey respondents chose five of these categories in roughly the same proportion, ranging from 61% to 73%. The only outlier was the company's IT department, which was selected by only 21% of respondents (see graph on next page).

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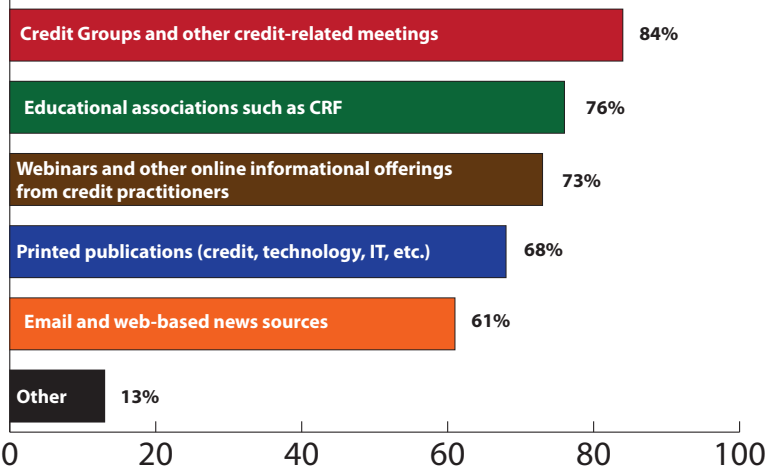
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CRF Survey Question on Sources of Technology Developments

Please indicate what resources you use to keep up with state-of-the-art technology designed for credit and accounts receivable functions. (check all that apply)



The "Other" Categories

CRF Survey Respondents were given an opportunity to add information resources that didn't fit into any of the six survey categories. The following is a sampling from that list:

- ✓ Our Parent company keeps us current with updates and PCI compliance.
- ✓ My company's business analyst department staff.
- ✓ I often just research online for solutions. I find products that look like they might be solutions and I speak with their salespeople.
- ✓ Cold calls from technology providers.
- ✓ LinkedIn is very helpful.
- ✓ We keep in close contact with existing banks, merchant services providers, existing software providers, and solution providers and have them update us on their latest technological advancements. They are a great source of information and must keep up in the marketplace as well.
- ✓ IT advances for other fields and areas that could have application to Credit and Accounts Receivable. For example, CRM [Customer Relationship Management] systems are primarily purchased for Sales and Customer Service. They could be helpful in Credit.
- ✓ The best sources of getting "state-of-the-art" technology tips & details is from our own Credit peers, as they are the ones that are digging into companies that play in these areas & completing RFPs on cutting edge credit & A/R tools! CRF also does a good job of bringing some of these tools to light, especially by providing SAP & Oracle platform tools & "best practices" as part of the CRF user group sessions, and also the CRF Open Forum portion of their events 3 times a year!
- ✓ Visiting customers and sharing ideas.
- ✓ Google alerts. (Editor's Note: for those who have free Google email accounts you may set up Google alerts on any topic. For example, you could set up a Google Alert for "Deduction Management Software." Anytime that term appears on the Internet, an email will be sent with links to the articles or web pages relating to "Deduction Management Software." To learn how to set up a Google alert, please [CLICK HERE](#).

Some Views on a few Technology Information Sources

The CRF News contacted several respondents from the CRF Survey on Sources of Technology Information to get their on-the-record comments. The following perspectives focus on credit groups and educational associations since they involve in-person interactions and networking.

Credit Group Participation

Michelle Jent, Credit & Collections Supervisor for Red Gold, a manufacturer of tomato-based products, pointed out that the primary mission of most Credit Groups is to share credit-related information on customers, as allowed by Anti-Trust laws. Members of her national manufacturing credit group submit questions for discussion, often focusing on credit processes and how to improve them. "I do get a lot of information that way, and for me being fairly new to credit, it's helpful for me," Jent said. Since she has become more involved lately in monitoring purchase orders, she was able to use this discussion to learn how other credit group members resolved PO errors.

Some credit groups invite service providers to their meetings to learn about products that may fulfill an operational need. Frank Sebastian, Director of Credit Services for adidas group, a maker of various kinds of sports shoes and other athletic gear, said he attends four credit group meetings per year, some of which include presentations by service providers about the latest technology available to improve credit and A/R processes. Those that appear worthwhile can be further researched.

Marty Rudisill, Director of Credit for Snider Fleet Solutions, a seller of truck tires, and Mike Pettyjohn, Director of Customer Financial Services for Danone, North America, producer of fresh dairy and other products, also referenced trade groups as a valuable asset to their research.

For Kris Skupas, Corporate Credit Manager at Schreiber Foods, her local food group of about 25-35 people is a good networking opportunity. "Sometimes we talk about challenges that are resolved by the latest technology," she said. Ms. Skupas noted, however, that credit groups are just one source for technology information. "I would not want to only use credit groups," she said. "All the sources I use give me a

good picture of what's out there regarding new technology. If I had to use just one source, I would choose the CRF EXPO," she added.

Educational Associations

Educational Associations that conduct conferences and vendor EXPOs, such as CRF and NACM, provide an opportunity to network with a large group of people. They also provide learning opportunities through presentations by credit experts.

Mr. Sebastian pointed out that his involvement with CRF introduced him to a service provider that has become instrumental in providing technology for his company's credit operations. "Had I not belonged to CRF, I probably would not have known who they were." He was more receptive to learning about new products at the CRF EXPO because the service providers are "non-pushy" in their approach. "If vendors could be more like that they would be more successful," he added.

Anna Mantel, Sr. Manager, Trade Risk, for A. Schulman, Inc., said that educational conferences, such as those held by CRF, allow her to learn how other companies have utilized various technologies. It was important for her to find out how the technology worked for companies in the same industry class in order to better assess its potential effectiveness. She likes to find out from other conference and EXPO attendees how a technology is working, whether it delivers the promoted results and whether it requires more options or bolt-ons.

As the CRF Survey revealed, credit professionals utilize most of the major information sources to learn about new technology that could provide a valuable boost to their company's credit and A/R performance. Staying attuned to these resources can reap significant rewards. Ms. Skupas offered the advice that, "You need to keep an ear and eye out there for what's available in case you need to make changes."



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Just a few thoughts from CRF's President, Bill Balduino



Bill Balduino
President, CRF

It is hard to believe that as I draft this note, we are about to enter the fourth quarter of 2015 – it truly is amazing how quickly this year is going by. With each **CRF News** that is released, I am afforded a unique opportunity to communicate some underlying message or concept to our readership. When addressing this quarter's note, I thought about a number of opportune areas for discussion:

- The success and energy of our recent August Forum and Exposition
- The incredible support we have received from Membership
- The partnerships that have been forged with our Platinum Partners and the Friends of the Foundation
- Our Board of Trustees who have supported the journey

But having my foundation as a credit risk management practitioner and as a student of process, I always try to find the root cause – the cause/effect if you will for any ongoing output or result. In this case, it was easy to discern and again worthy of callout in this short piece.

For those of you that were able to join us in Seattle, I echoed it from the front of the room to the 400+ that were in attendance!! Five consecutive sellouts, an all-time record attendance, the largest industry exposition in the U.S. – this STUFF doesn't just happen.

My comment at the time was about my personal focus and the focus for TEAM CRF: It has been about HUMILITY AND CREATING VALUE – value-based programs and materials for you, our CRF Family. The humility piece does however allow for some level of recognition for the TEAM I have the luxury of supporting. The modest success being achieved is due to a number of factors, but THEIR INDIVIDUAL AND COLLECTIVE EFFORTS ARE AT THE FOREFRONT OF IT ALL!!!!!!

While aware of this, it was certainly never more obvious than in Seattle when the CRF TEAM received some very thoughtful and heartfelt acknowledgements from our membership – IT WAS TOTALLY AWESOME TO WITNESS AND BE A VERY TINY PART OF...so pardon me, if for a moment, the HUMILITY is coupled with a resounding sense of GRATITUDE and PRIDE!!!!

So, to my TEAM I say a giant THANK YOU! There are those you see and interact with and those behind the scenes with whom you have little interface, but they are the TEAM, the GLUE, the FORCE that drives the outcomes and accomplishments.

Finally, as TEAM CRF you have our commitment to keep you, our membership, in the forefront of everything we endeavor to do and achieve together – we are committed to your success.

Thanks for taking a few minutes to share your thoughts:
billb@crfonline.org



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Have You Registered?

The CRF October Forum will be the 6th consecutive sellout. If you haven't registered yet, here's your ***last chance.*** [CLICK HERE.](#)



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Forum & *EXPO*
August 8 - 10, 2016
Sheraton — Chicago, IL



Forum
October 24 - 26, 2016
Marriott Harbor Beach
Ft Lauderdale, FL



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The Hazards To Secured Status Caused by Minor Mistakes In A Security Agreement

By: Bruce S. Nathan and David M. Banker
of Lowenstein Sandler LLP



A creditor seeking to obtain a security interest in a customer's personal property must satisfy all of the requirements for a valid and perfected security interest. They include the debtor's execution of a security agreement that adequately describes the secured indebtedness and the collateral securing payment of the claim. Any mistake in the security agreement, even a minor one, could be fatal to the creditor's secured status, particularly after the debtor files for bankruptcy.

That is the harsh lesson a lender learned being on the losing side with respect to the holding of the United States Court of Appeals for the *Seventh Circuit in State Bank of Toulon v. Charles E. Covey* (In re: Duckworth). The court addressed a minor error in the security agreement that mistakenly identified the secured debt as a non-existent promissory note dated December 13, 2008 instead of the correct promissory note actually dated two days later, December 15, 2008. The court also considered whether the bank could have fixed this error by reforming the security agreement following its borrower's bankruptcy filing.

The Seventh Circuit ruled that the Chapter 7 trustee in the debtor's bankruptcy case could avoid the bank's security interest as a result of the mistaken description of the bank's claim in the security agreement. The court also held that the trustee was not bound by state law rules, that might have otherwise enabled the bank to correct its mistake in the security agreement in the absence of the debtor's bankruptcy filing, based on the trustee's "strong arm powers" as a hypothetical lien creditor under the Bankruptcy Code.

That is really bad news for the sloppy creditor and an important lesson to avoid even minor mistakes in the description of the secured debt and the collateral in the security agreement.

Obtaining and Perfecting a Security Interest

A creditor seeking to obtain a security interest in a debtor's personal property must satisfy several requirements contained in Article 9 of the Uniform Commercial Code (the "UCC"). First, the creditor must satisfy the requirements for the creation or attachment of a security interest in a debtor's personal property. A creditor obtains a security interest when a debtor executes a security agreement that adequately describes both the secured indebtedness and the collateral securing payment of the claim.

Second, the creditor must perfect its security interest. Perfection ensures that a creditor's security interest in its collateral will withstand a challenge by another secured creditor, a judgment lien creditor and/or a bankruptcy trustee. A creditor frequently perfects its security interest by filing a UCC-1 financing statement in the appropriate filing office. A UCC-1 financing statement need not be signed by the debtor, and must identify the debtor by its correct legal name and adequately describe the collateral consistent with the description of the collateral in the security agreement.

The *Duckworth* case addressed a minor mistake in a bank's security agreement that ended up being fatal to the bank's secured status. The security agreement mistakenly referred to the secured indebtedness as a promissory note dated December 13, 2008. No such note existed; the actual note was dated December 15, 2008.

Facts

On December 15, 2008, David L. Duckworth borrowed \$1,100,000 from the State Bank of Toulon. Mr. Duckworth's promissory note was dated and signed on December 15. Duckworth had executed an Agricultural Security Agreement dated two days earlier, December 13, 2008. The security agreement granted the State Bank of Toulon a security interest in crops and farm equipment. However, the security agreement mistakenly described the secured indebtedness as the December 13, 2008 note. In fact, there was no promissory note dated December 13, 2008; the note the bank sought to secure was actually dated December 15, 2008.

Procedural History

In 2010, Duckworth filed a Chapter 7 petition in the United States Bankruptcy Court for the Central District of Illinois. Charles E. Covey was appointed Chapter 7 trustee. The bank filed two complaints in the bankruptcy court seeking recovery of the proceeds of the sale of its collateral. The trustee asserted counterclaims in both lawsuits, seeking a determination that the bank did not have a valid security interest in its collateral because of the minor error in the date of the note identified as the secured indebtedness in the security agreement.

The bankruptcy court ruled in favor of the bank, holding that its security interest was not defeated by the security agreement's mistaken reference to a non-existent December 13, 2008 note. The trustee appealed to the United States District Court for the Central District of Illinois. The district court affirmed the bankruptcy court's ruling, upholding the

validity of the bank's security interest, notwithstanding the security agreement's reference to a non-existent December 13, 2008 note.

The trustee then appealed to the Seventh Circuit. The Seventh Circuit had to decide whether the trustee could avoid the bank's security interest as a result of the error in the security agreement that mistakenly described the secured indebtedness as a non-existent note dated December 13, 2008 instead of the actual December 15, 2008 note.

The Parties' Arguments

The bank argued that the security agreement was enforceable against the original borrower and should have also been enforceable against the trustee. The bank relied on the terms of the security agreement itself, as well as evidence outside of the security agreement, to save its security interest. First the bank invoked the ambiguity of the security agreement in arguing for the applicability of the parol evidence rule and the admissibility of parol evidence outside of the four corners of the agreement to assist in interpreting the security agreement.¹ The parol evidence consisted of the testimony of both the debtor and an officer of the bank, who had prepared the agreement and the other loan documents, that the bank had made a mistake in its reference to the December 13, 2008 note in the security agreement. The bank also relied on the "composite document" rule² to read the security agreement and December 15, 2008 note together because they were executed as part of the same transaction. The bank finally argued that its transaction with the debtor satisfied the statutory requirements for an enforceable security interest under section 9-203 of the Uniform Commercial Code.³

The trustee relied on his strong arm powers, and his hypothetical lien creditor status to avoid the bank's security interest and block the bank from reforming the faulty security agreement (and thereby save the faulty security interest) by introducing evidence of a mistake describing the secured debt outside of the terms of the security agreement. The trustee also invoked another provision of Article 9 of the UCC, UCC section 9-201, which requires enforcement of a

security agreement according to its terms. The bank did not have a valid security interest in the collateral described in the security agreement because the security agreement had mistakenly identified as the secured indebtedness a non-existent note, the December 13, 2008 note, instead of the correctly dated December 15, 2008 note.

The Seventh Circuit's Decision

The Seventh Circuit sided with the trustee and held that the security agreement was not enforceable. The security agreement was unambiguous; it secured only a non-existent December 13 note and not the actual December 15 note.

The Seventh Circuit also rejected the bank's attempt to raise the parol evidence and composite document rules to correct the mistaken description of the secured indebtedness in the security agreement because they would allow the consideration of evidence outside of the four corners of the security agreement to connect the security agreement to the December 15, 2008 promissory note. The trustee was not bound by any external evidence outside of the security agreement that the bank had sought to introduce to reform the security agreement and otherwise correct the mistaken identification of the secured debt under state law.⁴ The trustee was not a party to the security agreement and the other loan documents. The trustee also could exercise his "strong-arm powers" as a hypothetical judicial lien creditor under Section 544(a) of the Bankruptcy Code to avoid any invalid security interest.

The Seventh Circuit relied on two other U.S. Circuit Courts of Appeals decisions in reaching its holding that the trustee could rely on the unambiguous text of the security agreement and the trustee's strong arm powers to avoid the bank's security interest and not be bound by parol evidence that could otherwise correct any mistake in the security agreement. The first decision was *In re Martin Grinding & Machine Work, Inc.*, also decided by the Seventh Circuit. The court held that parol evidence regarding the original parties' intentions was not binding on a bankruptcy trustee to correct a mistaken collateral description in a security agreement that failed to include accounts and inventory. Neither the UCC financing statement, which included accounts and inventory as part of the bank's collateral, nor the other loan documents, could expand the bank's collateral beyond the collateral description in the security agreement. The court noted UCC Article 9's central goal to increase the certainty, and reduce the cost, of present-day secured financing transactions. Later secured creditors should be able to rely on an unambiguous security agreement without having to worry that a prior secured creditor might offer parol evidence (which would ordinarily be unknown to the later creditor) to undermine the later creditor's security interest. If parol evidence could enlarge the description of collateral contained in an unambiguous security agreement, then a subsequent creditor could no longer rely on the security agreement to determine whether its collateral is subject to a prior security interest. Instead, that later creditor would be burdened with having to

1 The parol evidence rule governs the extent to which parties to a contract can introduce evidence of a prior or contemporaneous agreement in order to modify, explain, or supplement the contract at issue. Where the parties intended their written agreement to be the full and final expression of their bargain, by including language that the agreement constitutes the entire agreement of the parties and all prior agreements and understandings relating to the matters raised in the agreement are superseded by the terms of the agreement, then all other prior written and oral agreements are inadmissible for the purpose of changing the terms of the final agreement.

2 The composite document rule allows for documents executed by same parties in the course of the same transaction to be "construed with reference to one another because they are, in the eyes of the law, one contract."

3 Section 9-203 of the Uniform Commercial Code states that "[a] security interest is enforceable against the debtor and third parties... only if:

- (1) value has been given;
- (2) the debtor has rights in the collateral...; and
- (3) one of the following conditions is met:... the debtor has authenticated a security agreement that provides a description of the collateral..."

4 The court noted that the bank would have been able to obtain reformation of the security agreement as against the debtor/original borrower prior to the bankruptcy based on the mistaken reference to the December 13, 2008 note in the security agreement.

examine ancillary documents that would increase the cost of, and inject significant uncertainty into, secured transactions.

The Seventh Circuit, in *Duckworth*, also relied on the holding of the United States Court of Appeals for the First Circuit in *Safe Deposit Bank and Trust Co. v. Berman*. That case, like the *Duckworth* case, involved a mistaken description of the lender's secured indebtedness in the security agreement. There were multiple loans evidenced by multiple promissory notes executed over several years that referred to the same security agreement. Unfortunately for the lender, the security agreement identified the secured debt as only the amount owed under the initial promissory note. By the time of his bankruptcy, the borrower had fully repaid the initial note referenced in the security agreement. As a result, the security agreement, like the security agreement in the *Duckworth* case, referred to non-existent indebtedness, and accordingly, there was no existing indebtedness that could be secured under the security agreement.

The First Circuit held that the lender could not use parol evidence against the trustee to prove that the loans evidenced by the later promissory notes were secured by the original security agreement. First, those notes were not identified as indebtedness in the security agreement. The court also relied on the security agreement's omission of a "dragnet clause" stating that the collateral secured payment of all present and future indebtedness. The court noted that the absence of a dragnet clause precluded the lender in any litigation against the trustee from raising parol evidence to fix the error in the security agreement.

Finally, the Seventh Circuit, in the *Duckworth* case, rejected the bank's argument that its security interest was enforceable against the trustee because the transaction satisfied the requirements of the Illinois version of UCC section 9-203 for enforcing a security interest, namely, that value was given, the debtor had rights in the collateral and the debtor had signed the security agreement. The court agreed with the trustee's reliance on UCC section 9-201(a) which requires enforcement of the security agreement as written. Since the security agreement referenced the December 13, 2008 non-existent debt, the bank did not obtain a valid security interest.

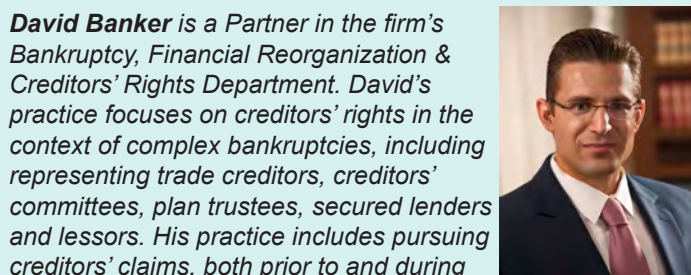
Conclusion

A secured trade creditor should be mindful to avoid even minor mistakes in its security agreement and other documents that might result in the loss of secured status. Bankruptcy trustees and other estate fiduciaries, such as creditors' committees, are usually searching for flaws, even minor defects, in security agreements and UCC financing statements that would be grounds for attacking a creditor's security interest. Dotting your I's and crossing your T's will go a long way to avoiding a horrible outcome!

About the authors:



Bruce S. Nathan, Partner in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Department, has more than 30 years' experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed, and is currently representing the liquidating trust and previously represented the creditors' committee in the Borders Group Inc. Chapter 11 case. Bruce also negotiates and prepares letters of credit, guarantees, security, consignment, bailment, tolling, and other agreements for the credit departments of institutional clients.



David Banker is a Partner in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Department. David's practice focuses on creditors' rights in the context of complex bankruptcies, including representing trade creditors, creditors' committees, plan trustees, secured lenders and lessors. His practice includes pursuing creditors' claims, both prior to and during bankruptcy proceedings, pre-bankruptcy planning from a creditor's perspective, negotiating the sale of claims, and defending claim objections. He represents the interests of secured creditors in matters including automatic stay litigation, adequate protection issues, cash collateral, and debtor-in-possession financing. David also has extensive experience representing lessors in connection with negotiating the terms of the assumption and cure of leases, adequate protection orders, and claims related to lease rejection.



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Collection Statistics

The Importance of Understanding Collectability of Delinquent Commercial Debts at Time Intervals, at Due Date and After

The importance of cash flow is undeniable. Any business principal, from a sole proprietor to a CEO overseeing several thousand employees, knows this to be true. Cash flow is paramount. No matter how effective the sales force operates, if the money isn't coming in, everything comes to a screeching halt.

If firms relax their payment requirements to accommodate these economically challenging times, a dangerous groundwork may be set for the ultimate slowdown of cash flow.

A survey by Commercial Collection Agencies of America shows that the probability of full collection on a delinquent account drops drastically according to the length of the delinquency. In as little as three months, the probability of collecting a delinquent account drops to 68.9%. After six months, collectability drops to 51.3% and after one year, the probability of ever collecting delinquent accounts drops to 8.9%.

It is therefore easy to see the importance of taking quick action when an account ages past its due date. Annette M. Waggoner, Executive Director of Commercial Collection Agencies of America notes, "Today's competitive economy requires that companies maintain a healthy cash flow with the ability to adapt to constantly changing market conditions

This is true whatever the industry. Delinquent accounts, if they are permitted to age, can wreak havoc on a company's liquidity, as well as tie up management and staff time that could be put to better use. Companies must take a hard line on past due receivables, and turn to professional assistance when their internal efforts have not proven successful."

"Companies must take a hard line on past due receivables, and turn to professional assistance when their internal efforts have not proven successful."

Annette Waggoner, Executive Director of Commercial Collections Agencies of America

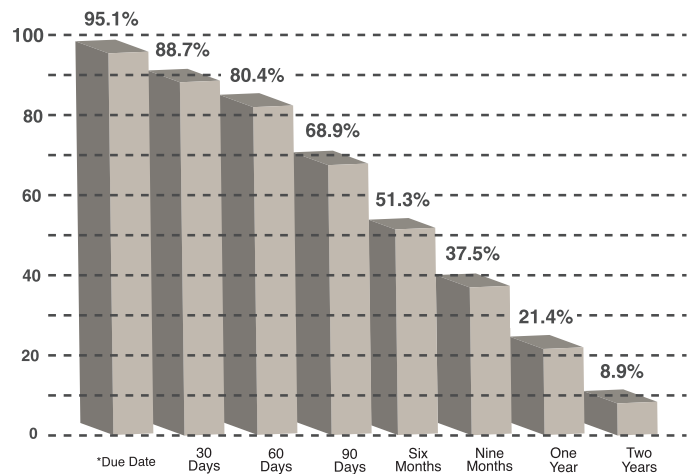
Commercial Collection Agencies of America polled its member's agencies which handle approximately \$12 billion in commercial claims. The results are offered in the chart below and serve as a simple and graphic reminder of the relationship between aging and collectability.

For more information on Commercial Collection Agencies of America, please contact:

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www.commercialcollectionagenciesofamerica.com

Collectability of Delinquent Commercial Debts At The Due Date and Afterwards



LENGTH OF DELINQUENCY IN MONTHS SINCE DUE DATE

*For some industries the due date may be several months after the delivery date
Source: Commercial Collection Agencies Of America

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Commercial Collection Agencies of America has an independent Standards Board which sets the requirements for agency certification.

For more information, please contact Executive Director, Annette M. Waggoner at awaggoner@commercialcollectionagenciesofamerica.com or call 847-907-4670 or visit our website at www.commercialcollectionagenciesofamerica.com

Another Circuit Court Holds That A First-Time Transaction Can Satisfy the Ordinary Course of Business Defense for a Preference Claim

By Hon. Melanie L. Cyganowski (Ret.) and Kevin Zuzolo of Otterbourg P.C.



Creditors facing preference actions will want to explore every possible defense and creditors may be able to defeat a preference claim or reduce their exposure by asserting the ordinary course of business defense. In its simplest terms, the defense applies if the creditor can demonstrate that the challenged payments were made in the ordinary course of business of the debtor and the creditor. There are two prongs to the ordinary course of business defense. The first prong is known as the “subjective test” and requires demonstrating that the challenged transfer was in the ordinary course of business with respect to the debtor and the transferee. The second prong is known as the “industry test” and requires demonstrating that the challenged transfer was made in accordance with ordinary business terms in the relevant industry. This article focuses on satisfaction of the subjective test.

Invoking the ordinary course defense under the subjective test often involves detailed spreadsheets and an analysis of the payment history between the debtor and creditor, including payment terms, the length of time between invoice date and payment date, and standard deviations. But what if the challenged payment represents the first and only time the creditor has entered into a transaction with the debtor? Can the ordinary course of business exception offer any protection when there is no prior business relationship between the parties? The courts are not all in agreement, but a recent decision by the Court of Appeals for the Tenth Circuit held¹ that the ordinary course of business exception can apply to a first-time transaction² (thereby joining the Sixth, Seventh, and Ninth Circuit Courts that have previously held the same). This precedential decision will give creditors additional ammunition to fight this type of alleged one-off preferential transfer.

The Basics: Preferences and the Ordinary Course of Business Defense

A preference payment is a payment made by an insolvent debtor to a creditor on account of an antecedent debt made within 90 days before the filing of a bankruptcy petition. Pursuant to Section 547(b) of the Bankruptcy Code, a trustee may avoid a preferential payment and recover the funds for the benefit of the debtor’s estate. This allows the recovered funds to be distributed equally among all of the debtor’s creditors. Exceptions to the trustee’s avoidance power are

¹ The Court of Appeals for the Tenth Circuit is one of the eleven “highest” appellate courts in the United States, with the only higher court being the United States Supreme Court. The decisional law of the Tenth Circuit is binding upon the federal courts that sit in Colorado, Kansas, New Mexico, Oklahoma, Utah, and Wyoming.

² *Jubber v. SMC Elec. Prods. (In re C.W. Mining Co.)*, 2015 U.S. App. LEXIS 13981, Case No. 13-4175 (10th Cir. August 10, 2015).

also built into the preference statute, including the ordinary course of business defense. Pursuant to Section 547(c)(2) of the Bankruptcy Code, a trustee may not avoid a transfer “to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor” when “such transfer was . . . (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms.”

Prior to the amendments to the Bankruptcy Code in 2005, in order to satisfy the ordinary course of business exception, a defendant was required to prove both subparagraph (A) (the subjective test) and subparagraph (B) (the industry test) – i.e., that the payment was made in the ordinary course and that it was made according to ordinary business terms. The amendments in 2005 gave some relief to preference defendants by making subparagraphs (A) and (B) alternatives and requiring a preference defendant to prove only one or the other. The preference defendant has the burden of establishing the defense by a preponderance of the evidence.

The Tenth Circuit’s Decision: *Jubber v. SMC Electrical Products Inc. (In re C.W. Mining Co.)*

The Facts

In June 2007, C.W. Mining Company (the “debtor”) agreed to purchase used electrical equipment and related services from SMC Electrical Products, Inc. (“SMC”). The purpose of the transaction was for the debtor to change from a continuous-mining method to a longwall system that would potentially increase its mining capacity by a factor of four to five.³ On September 18, 2007, SMC issued an invoice for the parts and services in the amount of \$805,539.75. The debtor made multiple partial payments to SMC after the September 18 invoice, including a wire transfer in the amount of \$200,000 on October 16, 2007. On January 8, 2008, the debtor was forced into bankruptcy after creditors filed an involuntary petition.

The October 16 transfer of \$200,000 was made within the 90 days before the petition was filed and the bankruptcy trustee (“Trustee”) sought to recoup the \$200,000 for the bankruptcy estate by filing a preference action against SMC. The Bankruptcy Court for the District of Utah granted SMC’s motion for summary judgment finding that the debt was incurred and the payment was made in the ordinary course of business under the subjective test – hence it was not an

³ Longwall mining is a form of underground coal mining where a long wall of coal is mined in a single slice (typically 0.6 – 1.0 m thick).

avoidable transfer.⁴ The Bankruptcy Appellate Panel for the Tenth Circuit affirmed⁵ the decision of the Bankruptcy Court and the Trustee appealed to the Tenth Circuit. The Trustee argued that the lower courts erred because the transaction between the debtor and SMC was the first time that the parties had dealt with each other and, therefore, it could not satisfy the subjective test of the ordinary course of business exception.

Policy Considerations

The Tenth Circuit Court first examined the general policy of avoidance actions and the ordinary course of business exception. The purpose of the preference section is two-fold: First, it facilitates the bankruptcy policy of equal distribution among creditors by requiring a creditor that received greater payment than others to disgorge funds so that all creditors may share equally. Second, it discourages creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy.

The exceptions to the trustee's avoiding powers also advance significant bankruptcy policies. The Court explained that the ordinary course of business exception was intended to leave normal financial relations undisturbed because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or its creditors during the slide into bankruptcy. Even if one creditor receives greater payment from a transfer during the preference period, the ordinary course of business exception may benefit all creditors by deterring the race to the courthouse and enabling the debtor to continue operating its business.

First-Time Transactions and the Ordinary Course of Business Defense

The Court next considered whether a transfer made pursuant to a first-time transaction could qualify for the exception under the subjective test. First, the Court noted that the incurrence of the debt and the payment of the debt must be in the ordinary course for both the debtor and the transferee. The uncertainty regarding a first-time transaction arises because some courts have required that the incurrence of the debt and the payment be in the ordinary course of business between the debtor and the transferee. Under that standard, as noted by the Court, any first-time transaction would appear to be automatically ineligible for the exception because there is no prior course of dealing between the parties.

The Court agreed, however, with the three other circuits that have held that a first-time transaction can qualify for the ordinary course of business exception. As is often the case, the correct interpretation of a law begins with the statute itself, and the Court noted that the statute refers to the ordinary course of business of the debtor and transferee, not between the debtor and transferee. The Court also reasoned that this interpretation fits the purpose of the exception because it encourages a potential creditor to extend credit to a new customer in questionable financial circumstances.

⁴ *Rushton v. SMC Elec. Prods. (In re C.W. Mining Co.)*, 2013 Bankr. LEXIS 1005, Adv. Pro. No. 10-02758 (Bankr. D. Utah March 15, 2013).

⁵ *Rushton v. SMC Elec. Prods. (In re C.W. Mining Co.)*, 500 B.R. 635 (B.A.P. 10th Cir. 2013).

With respect to the payment prong, the Court noted that courts commonly look to four factors to determine whether a payment was made in the ordinary course of business of the debtor and the transferee: (1) length of time the parties were engaged in the type of dealing at issue; (2) whether the amount or form of tender differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection or payment activities; and (4) the circumstances under which the payment was made. For first-time transactions, however, the court may refer solely to the written terms of the transaction to define the ordinary course of business between the parties.

The Court's Analysis

Applying the above principles to the facts of this case, the Court concluded that the \$200,000 transfer to SMC was protected by the ordinary course of business exception. First, the Court held that the debt was incurred in the ordinary course of business because the purchase was an arm's length transaction and the undisputed purpose of the purchase was to assist the debtor with its mining operations. The Court rejected the Trustee's argument, which boiled down to simply that the debt was incurred as part of a first-time transaction. Second, the Court held that the payment was made in the ordinary course of business because the \$200,000 payment was made two days before the due date, it came from the debtor's own bank account, and there was no evidence of collection activity by SMC.

Perhaps recognizing that the Court's ruling could substantially limit the transactions that a trustee could attack as preferential transfers, the Court made an effort in its opinion to explain that there is still "real teeth" in the ordinary course requirement. The Court cautioned that certain first-time transactions, in which a failing business enters into a risky transaction in an attempt to save its business, will not usually be afforded the protection of the ordinary course of business exception. The rationale is that a troubled company sliding into bankruptcy may have an extra incentive to engage in a risky investment because the company will reap all of the benefits of success, but the creditors will bear the downside if it fails. A debt incurred under these circumstances should not be repaid to the detriment of other creditors.

Was it Really an Ordinary First-Time Transaction?

It is interesting that the Tenth Circuit Court's decision focused much more on whether the debt was incurred in the ordinary course than whether the payment was made in the ordinary course. As noted above, both the incurrence of debt and the payment must satisfy the subjective test of the ordinary course exception. In the C.W. Mining case, the incurrence of the debt with SMC was a first-time transaction, but the challenged payment was not necessarily a first-time transaction. Although it was not explained in the Tenth Circuit Court's ruling, the decision below from the Bankruptcy Appellate Panel notes that the debtor made a total of five payments to SMC with respect to the September 18 invoice.⁶ Presumably, the first four were made outside of the 90 day preference window and were not challengeable by the Trustee, but this arguably provided the Trustee with a history of payments to compare with the challenged transfer.

⁶ 500 B.R. at 644 (B.A.P. 10th Cir. 2013).

Moreover, the Trustee had argued that the payments came from different accounts of the debtor, that none of the payments actually corresponded to the invoiced amount or the established progress payments, and that the invoice labeled the payment terms as “Special.” It appears that the Court had enough facts at its disposal to conclude that the challenged payment was not made in the ordinary course and did not satisfy the payment prong. This is especially true when viewed in the context of the Court’s own statement that, for first-time transactions, it may refer solely to the written terms of the transaction to define the ordinary course of business between the parties. Fortunately, for the creditor, the Court conducted a minimal analysis of the payment prong.

Also interesting is that the Tenth Circuit Court hinted that the transaction with SMC may have been a transaction in which the debtor was gambling with creditors’ money. In a footnote, the Court noted that evidence in the appellate and bankruptcy records indicated (1) that the debtor stated in public records in 2000 that the mine was not amenable to longwall mining; (2) that the coal quality and rate of production was much lower than for similar operations elsewhere; (3) that the acquirer of the debtor’s operations reinstated continuous mining; and (4) the removal of longwall equipment (which was of doubtful value) was expensive. The Trustee, however, neither alerted the Court to that evidence nor argued that the transaction was a “gamble” and the Court was not inclined to make the case for the Trustee.

Conclusion

As a result of the Tenth Circuit Court’s C.W. Mining decision, another Circuit Court has adopted the view that a first-time transaction can qualify for the ordinary course of business exception. It remains to be seen whether other circuit courts, particularly the Second and Third Circuits, will adopt the same view. Without binding precedent in these circuits, there is less certainty for creditors defending preferences that arise from one-off transactions. As it stands now, at least one bankruptcy court in Delaware has ruled that a single

transaction may fall within the ordinary course exception.⁷ In New York and the Second Circuit, the courts have recognized that a first time transaction may qualify for the ordinary course of business defense, but also note that a qualifying first-time transaction must have been the type that could have been a recurring, customary transaction.⁸

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⁷ *In re US Office Products Co.*, 315 B.R. 37, 40 (Bankr. Del. 2004).

⁸ See, e.g., *Official Comm. of Unsecured Creditors of Enron Corp. v. Martin (In re Enron Creditors Recovery Corp.)*, 376 B.R. 442, 462 (Bankr. S.D.N.Y. 2007).



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Involuntary Bankruptcy: Like All Potent Weapons, It Must Be Handled With Care

By Joseph Coleman
Kane, Russell Coleman & Logan PC

Very few Creditors have ever been involved in filing an involuntary bankruptcy. Yet with relatively little cost and with minimal evidence (unless the involuntary bankruptcy petition is contested), petitioning creditors can invoke one of the most all-encompassing injunctions in all of jurisprudence, namely the automatic stay. An involuntary bankruptcy is easily commenced by the filing of a two-page petition certified by at least three creditors that they have properly due, owing and unpaid debts. The filing of an involuntary bankruptcy that is not contested by the debtor, results in an order of relief being entered and the Chapter 11 or Chapter 7 bankruptcy case begins the same as any other case. Then why aren't more credit professionals using involuntary bankruptcy petitions as a weapon in their arsenal? I would submit there are two primary reasons: (1) there is meaningful downside to petitioning creditors who do not properly file involuntary bankruptcies (note the caveat above regarding petitions that are "not contested"); and (2) bankruptcies generally mean very little return to unsecured creditors, so why would an unsecured creditor actually want to cause such a bankruptcy? Notwithstanding these very legitimate negatives against commencing an involuntary bankruptcy, such a strategy--after proper due diligence and for a specific, legitimate reason--can be very effective.

The following will provide an overview of involuntary bankruptcy, including what is necessary to commence a bankruptcy against a debtor. The focus will then be on the meaningful downside to creditors who misuse involuntary bankruptcies. There will also be an emphasis on the importance of due diligence requirements and an examination of the strategic reasons to consider involuntary bankruptcy as a weapon in a credit professional's arsenal.

Overview and Requirements. Section 303 of the Bankruptcy Code provides that "three or more creditors" whose debts are "not contingent as to liability or the subject of a bona fide dispute as to liability or amount. ..." may commence an involuntary bankruptcy case against an entity under Chapter 7 (liquidation) or Chapter 11 (reorganization). Such three petitioning creditors must be owed non-contingent, undisputed claims in the aggregate of at least \$15,325. If a debtor has fewer than twelve (12) total creditors, excluding claims owed to employees or insiders,

then one or more petitioning creditors may commence a filing of an involuntary bankruptcy. Immediately upon filing the involuntary petition, the automatic stay is invoked. A debtor then has a period of time in which to either contest or consent to the involuntary bankruptcy. This interim period is known as the "gap period," during which the alleged debtor may continue to operate its business as normal.

Order of Relief. An alleged debtor may contest an involuntary bankruptcy case. The key issue upon whether an involuntary bankruptcy petition should be permitted over the objection of a debtor is whether the "debtor is generally not paying such debtor's debts as such debts become due unless such debts are subject to a bona fide dispute as to liability or amount." 11 U.S.C. §303(h)(1). Alternatively, a court can grant an involuntary petition over the debtor's objection if within 120 days before the filing of the petition, a custodian, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession. 11 U.S.C. §303(h)(2).

Accordingly, if the creditors' debts are not disputed and the debtor is, in fact, generally not paying its debts as they become due, then a court should enter an order of relief and commence a bankruptcy case similar to a voluntary filing.

Potential Downside. Along with the relatively simple and cost-effective remedy of commencing involuntary bankruptcy cases comes a significant corresponding responsibility. In short, creditors who improperly or without the requisite due diligence commence involuntary bankruptcies will suffer the consequences of their actions. Involuntary bankruptcies should not be used as a substitute for a collection suit, as a litigation tactic, as a means solely to collect one particular creditor's debt, as a means to destroy a competitor or other bad faith reasons. Petitioning creditors who file an involuntary bankruptcy in bad faith has a significant downside. Section 303(i) allows the bankruptcy court to award attorneys' fees and costs against a bad faith petitioning creditor together with damages proximately caused by the improper filing. In addition, a court can award punitive damages against a creditor who acts in bad faith

in filing an involuntary petition. This is the only place in the Bankruptcy Code that expressly provides for the award of punitive damages.

Frankly, this downside is not unreasonable: filing an involuntary bankruptcy petition in and of itself causes the potential debtor to be subject to the automatic stay and the involuntary debtor's customers, vendors, lenders and others will perceive the company as being in bankruptcy. The "gap period" can be a very difficult time for the potential debtor. Given the potential damage an involuntary debtor may suffer until it has a chance to prove, for example, that the petitioning creditors' claims are subject to a bona fide dispute or that the involuntary debtor is paying its undisputed debts as they generally come due – it is appropriate that bad faith petitioning creditors have some downside. There are two recent cases that emphasize this downside. In *In re Murray Rosenberg*, 779 F.3d 1254 (2015 11th Cir.), the Court awarded in excess of \$1,000,000 in attorney's fees as damages for an improperly filed involuntary bankruptcy petition, including attorneys' fees for defending appeals. In the *Rosenberg* case, DVI Receivables XIV and five affiliates commenced an involuntary bankruptcy case against *Rosenberg* based upon the petitioning creditor's view that *Rosenberg* had purportedly guaranteed certain debts related to medical equipment leases. *Rosenberg* successfully opposed the involuntary petition asserting that his guarantee did not run in favor of the petitioning creditors and they, therefore, had no claims against him. What immediately jumps out from this fact situation is that (1) the petitioning creditors were all affiliates, thereby suggesting the involuntary bankruptcy petition was a litigation strategy or part of a two-party dispute, instead of involuntary petition for the benefit of all creditors; and (2) significant questions existed about whether the petitioning creditors were the beneficiary of the guaranty agreement, evidencing a meaningful level of "bona fide dispute" as to the nature of the petitioning creditors' claims. Similarly, in *In re TPG Tour LLC*, 2015 WL 4220619 (2d Cir. July 14, 2015), the Second Circuit affirmed the bankruptcy court award of \$513,427 in attorneys' fees. In this second example of misuse of the involuntary bankruptcy process, the petitioning creditors claimed they were owed amounts based on certain promissory notes, which the alleged debtors had neither issued nor guaranteed. Moreover, the alleged debtor had sold their interests in the issuing subsidiaries long before their default. To make matters worse, the petitioning creditors had previously commenced multiple lawsuits against the debtors in different jurisdictions before they filed an involuntary bankruptcy petition against the alleged debtors, asserting they were liable for the former subsidiaries' debts pursuant to an alter ego theory. This fact situation just screams "bona fide dispute" given the "plethora of ongoing litigation" between the parties and the fact intensive and difficult burden of succeeding upon an alter ego claim. With regard to what constitutes a bona fide dispute, the Second Circuit explained that "Congress intended to disqualify a creditor whenever there is a legitimate basis for the debtor not paying the debt, whether that basis is factual or legal." *Id.* at 4. Moreover, "[a]n involuntary bankruptcy case cannot be a means of pressuring a debtor to pay a legitimately disputed debt." *Id.* Both the *Rosenberg* and *TPC* cases show that rather extreme misuses of the involuntary

bankruptcy process as a litigation tactic or in furtherance of a two party dispute will not be tolerated. A bankruptcy process, in sharp contrast, is designed to treat all similarly situated creditors the same and not as a forum to pursue two-party disputes.

Due Diligence. Due Diligence. Due Diligence: Having filed many involuntary bankruptcies in several states, I have developed a very strong affection for proper due diligence. I do not want to find out that one of my petitioning creditor's claims is subject to a bona fide dispute or that the debtor is paying the majority of its debts as they generally come due from the debtor in answering the involuntary complaint. I want to know with relative certainty before filing an involuntary petition that (a) the petitioning creditors' debts are neither contingent nor subject to a bona fide dispute as to liability or amount; and (b) that the debtor is in fact not paying its debts as they become due. I attempt to obtain more than a minimum three petitioning creditors; in fact, the more the merrier. If the petition is filed with five or six petitioning creditors and the debtor is able to contest one petitioning creditor's debt as subject to bona fide dispute, I still have more than the statutorily mandated three petitioning creditors. Moreover, numerosity shows the debtor and the judge that there is a ground swell of support for the involuntary petition. With regard to the generally paying debts as they come due standard, the courts will look at a variety of factors including (1) regularly missing a number of payments, which are significant in amount in relation to size of debtor's total payments; (2) the number and amount of unpaid debts, (3) the duration of the non-payment, (4) materiality of non-payment, and (5) the manner in which the debtor is conducting its financial affairs. This is a case-by-case inquiry such that no one factor is determinative. Accordingly, the more petitioning creditors the better, as that confirms that a greater number of debts are not being paid in a timely manner. The creditors have to satisfy themselves that the debtor in fact is not paying its debts as they generally come due as a condition to filing the bankruptcy petition. Otherwise, the cost benefits of filing the involuntary bankruptcy petition simply do not make sense.

Have A Strategic Reason For Commencing The Involuntary Bankruptcy: Given the reality that unsecured creditors often do not receive a generous distribution from bankruptcies, I believe there must be specific and strategic reasons for commencing an involuntary bankruptcy. The fact that a particular creditor is angry that they have not been paid will not cut it. As an example, I filed an involuntary bankruptcy petition in Florida when a retail debtor operating in several states had essentially commenced an going out of business sale, without calling it such, by buying no more product, ceasing to pay for inventory delivered, and simply liquidating the inventory for the benefit of its asset based lender. The petitioning creditors knew they were not going to receive any payment at the end of the day if the debtor just continued its informal liquidation. Being well informed about the industry, the petitioning creditors believed strongly that a going concern sale was possible. Accordingly, after full due diligence, an involuntary bankruptcy was commenced, to which the debtor had no choice but to consent. The debtor retained a CRO, who closed unprofitable stores, strategically

moved the existing inventory to maximize the fill rate and the sales of the remaining stores, conducted a going concern sale and delivered a meaningful distribution to unsecured creditors. Other strategic reasons to consider filing an involuntary bankruptcy include: (1) the debtor is only paying debts that the principals have guaranteed; (2) removal of property or sales outside the ordinary course of business; (3) the secured lender is taking control of debtor; (4) significant insider transfers; (5) the debtor's selective payments to only certain creditors; (6) trapping significant preferential transfers, since the 90-day period begins with the filing of the involuntary petition; (7) control the location of an imminent bankruptcy case; (8) a means of potentially removing incompetent management, resulting in the appointment of a trustee or a chief restructuring officer; (9) providing a forum to avoid additional liens given to a secured lender who provided no new value; (10) prevent a foreclosure sale when questions exist about the perfection of security interests or the secured lender's conduct; and (11) a judgment creditor who is about to execute upon the debtor's only remaining unencumbered property. These are only examples - many other situations similarly may justify considering to file an involuntary bankruptcy. The point is to have a strategic reason for commencing an involuntary bankruptcy.

Conclusion: In light of the Rosenberg and TPG cases, the downside of improperly filing involuntary bankruptcy petitions is receiving a lot of attention, and appropriately so. However,

in each of those cases, unequivocal bona fide disputes existed in the petitioning creditors' claims against the debtor. Moreover, the involuntary bankruptcy process was misused as a two-party litigation tactic. What these cases represent is additional justification for proper and meaningful due diligence prior to filing any involuntary bankruptcy petition. Moreover, in light of the potential downside, the creditors should have a specific reason and strategic purpose for commencing an involuntary bankruptcy. With proper due diligence and an articulated purpose, involuntary bankruptcy can be a tremendously powerful weapon in the credit professional's arsenal.

About the Author:

Mr. Coleman is a founding director of Kane Russell Coleman and Logan PC, where he chairs the Insolvency, Bankruptcy and Creditor Rights practice group. His team has represented 38 Creditor Committees in 16 states together with every other facet of credit rights and bankruptcy representation. His firm was recently named among the top 20 mid-sized law firms in the nation by The National Law Journal.



UPDATE ON CRF MAJOR RESEARCH INITIATIVE

Steven C. Isberg Ph.D., CRF Senior Research Fellow and Associate Professor of Finance, Merrick School of Finance (University of Baltimore) will advise the membership of his early findings on this key research initiative designed as an Organizational Structure Research Project. The primary objective of this study is to gain a contemporary perspective on the design of the credit and accounts receivable functions. Steve will offer a review of the high level findings of the initial interviews conducted in support of this initiative at the [October CRF Forum in Ft. Lauderdale, Florida](#).

Dr. Isberg will then offer an expanded version of his research effort at our CRF Forum in March, 2016 in Marina Del Rey, CA. The March offering will include a detailed look at the findings, interpretations and insights associated with the project, which will offer expanded participation from CRF membership, and will also address key performance indicators for varying organizational structures.



Dr Steve Isberg
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Robust Support for the Expansion

By Mark Zandi
Moody's Analytics

Recent Performance

Notwithstanding the recent decline in stock prices and increased volatility in financial markets, the U.S. economy is performing well, and its prospects for at least the next several years are good. There are some clear threats to this optimism, the most obvious being China's mounting problems and the normalization of U.S. monetary policy. But while there are threats to our economy, they seem about as less-threatening as they have in years.

Help wanted

The economy's strong performance is most evident in the labor market, which is creating a robust and rock-solid well over 200,000 jobs per month. This is approximately double the growth in the labor force, and thus the remaining slack in the labor market is quickly being absorbed. The estimated underemployment gap – the percent of the labor force that is underemployed – has fallen below 1%. At the current pace of job growth, if sustained, the underemployment gap will disappear and the economy will be at full-employment by summer 2016. There is no reason to believe that job growth will slow any time soon given the recent surge in job openings to a record high and the rock-bottom number of layoffs.

There is a reasonable debate regarding why wage growth remains so pedestrian, and whether this signals that the job market has more slack than thought or that the link between a tightening job market and wage growth has been impaired. More likely, businesses are doing everything they can to avoid bigger pay increases for their workers, which is very typical particularly coming out of a period with a slack job market. However, the rapidly increasing number of open job positions suggests this is no longer working (see Chart). A substantive pick-up in wage growth appears imminent.

Consumer tailwinds

This doesn't augur well for businesses' profit margins, but they are currently about as wide as they have ever been. The stronger pace of wage growth should lift the spirits of consumers, many of whom are still skeptical about the recovery's staying power, and thus their spending. Indeed, the tailwinds behind consumers are blowing steadily stronger.

In addition to the better job market, consumers are benefiting from higher house prices and stock values (the recent correction notwithstanding), and very low debt burdens.

Credit is also flowing more freely. Auto credit is notably ample, and credit- and retail-card lending are back to normal. Even home-equity lending has come back to life, as the higher house prices have increased homeowners' equity and lenders are more comfortable

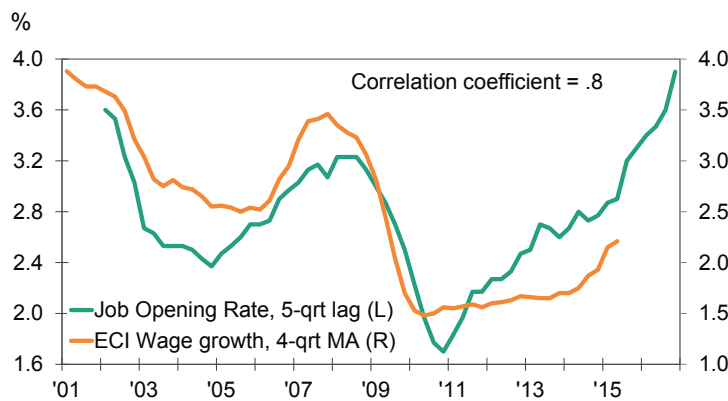
extending loans given much-improved credit quality. Originations of household credit, excluding first mortgages, are back to pre-recession levels

There is also evidence that it is a bit easier to qualify for a first mortgage loan to purchase a home. FHA's decision to lower its insurance premiums at the start of the year, and Fannie Mae and Freddie Mac's new 97% loan-to-value ratio loan program appear to be having some effect. Lenders also appear more comfortable in selling loans to Fannie and Freddie since the mortgage giants made recent changes to their policies reducing the risk that lenders will need to repurchase loans that eventually get into trouble. A normalization of mortgage credit availability is vital to the full return of the first-time homebuyer to the housing market. And first-timers are essential to getting the housing recovery back on track.

Pent-up households

Housing and the broader economy should also receive a lift from a substantial acceleration in household formations.

Wage Growth is Set to Accelerate Strongly



Sources: BLS, Moody's Analytics



Millennials in their twenties have delayed forming households given the tough economy and their weighty student loan debt. This is about to change in a big way.

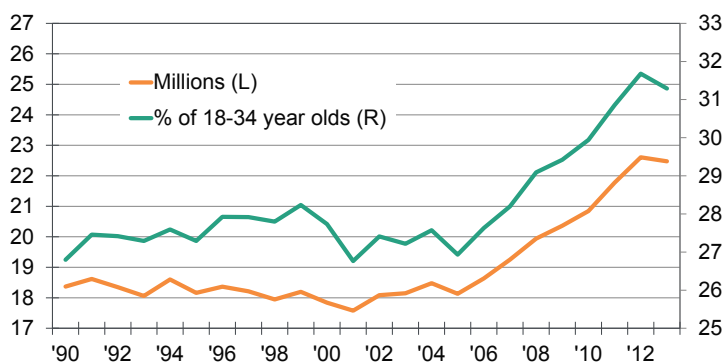
According to the Census Bureau, there are close to 3.5 million more 18 to 34 year olds living with their parents today than before the recession (see Chart). Even assuming some doubling- and even tripling-up, this group represents an additional close to 1.5 million new households set to form. Let's say that these households form through the remainder of the decade, creating an additional 300,000 households each year. This would be on top of the 1.25 million households that should form each year given normal demographic trends. This suggests that on average 1.55 million households (1.25 million plus 300,000) should be formed each year between now and the end of the decade. This is up from the estimated 1 million households formed last year.

So many new households will require more homes and everything that goes into them. Demand for apartments will be especially robust as twenty-somethings generally rent and the Millennials seem to prefer urban living. Indeed, the apartment market is booming with multifamily construction as strong as it has been since the tax-juiced boom of the mid-1980s.

However, single-family housing will also enjoy stronger demand as the

Lots of Pent-Up Households

18-34 year olds living with their parents

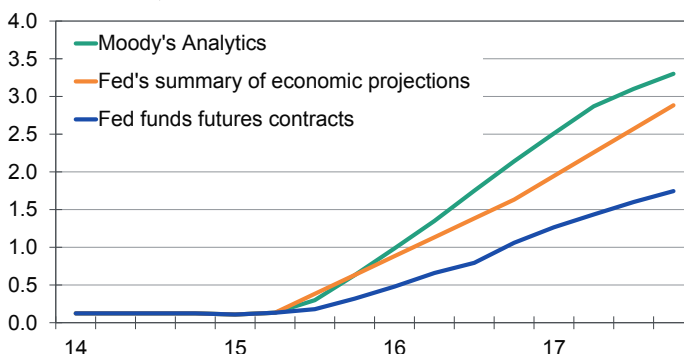


Sources: Census, Moody's Analytics



Fed and Financial Markets Aren't on Same Page

Fed funds rate, %

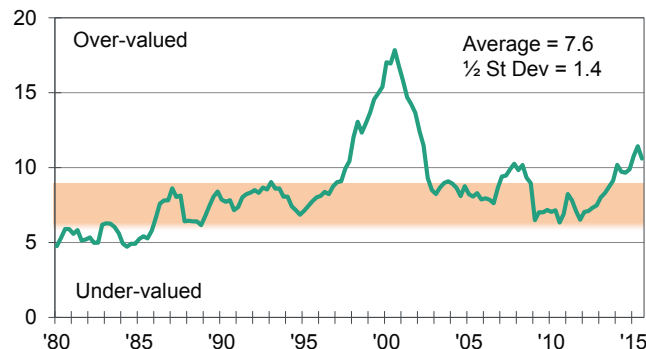


Sources: Federal Reserve, CME Group, Moody's Analytics



Stocks Appear Overvalued

Ratio of Wilshire 5000 and corporate profits, %



Sources: Wilshire, BEA, Moody's Analytics



median age of the first-time homebuyer is about 33 years old. The heart of the Millennial Generation is now 26 years old. Millennials may wait a bit longer than their parents to get married and raise a family in a single family home, but so far the evidence suggests they aren't waiting too much longer.

Fed vs. markets

The normalization of Federal Reserve monetary policy poses a serious challenge to any optimism regarding the U.S. economy's prospects. The Fed's balance sheet is bloated with Treasury and mortgage securities after several rounds of quantitative easing and short-term rates remain exceptionally low.

This is not consistent with an economy at full-health, and the Fed has plans to right-size its balance sheet over time by allowing the securities on its balance sheet to mature and prepay. Policymakers also expect to slowly, but steadily raise short-term rates as the economy achieves full employment and underlying inflation returns to the Fed's target of 2%.

Forecasts of the federal funds rate by Fed members put the federal funds rate at close to 2% by year-end 2016 and 3% by year-end 2017. In the long-run, when the economy is at full-strength, the funds rate should settle somewhere between 3.5% and 4%. This outlook is very similar to my own.

Although this script appears reasonable, financial markets appear to have a very different one. Based on the funds rate expectations implied by the federal funds futures market, investors believe that the funds rate will be no more than 1% by year-end 2016 and 2% by year-end 2017. The funds rate in the long-run is also not expected to rise above 3% (see Chart).

Somebody is wrong. If it is the financial markets, then investors will have to adjust, potentially causing bond yields and credit spreads to spike, stock prices to fall, and commodity and foreign exchange markets to gyrate. This is what happened in summer 2013 when then-Fed Chairman Ben Bernanke openly considered the possibility of ending QE. This surprised investors and the resulting so-called taper tantrum did significant damage to many emerging economies that rely on capital inflows and our own housing market as mortgage rates jumped.

Exacerbating the threat that financial markets suffer another bout of volatility that hurts the economy is the seeming thinness of transactional liquidity in markets. That is, it appears that trading in markets isn't as deep as it was prior to the financial crisis, causing prices for financial assets to swing more widely in response to events. While there is substantial debate around how serious a problem this is and its causes, it can't be dismissed as a concern.

It is also reasonable to worry that any adjustment in financial markets would be aggravated by high valuations for many assets. The recent correction in stock prices was surely due in part to the fact that the market was very richly valued. Before the correction, even Fed Chair Janet Yellen called-out the stock market – and specifically biotechnology stocks – as being overvalued (see Chart). Valuations have also been seemingly high in the junk corporate bond market and some commercial real estate markets.

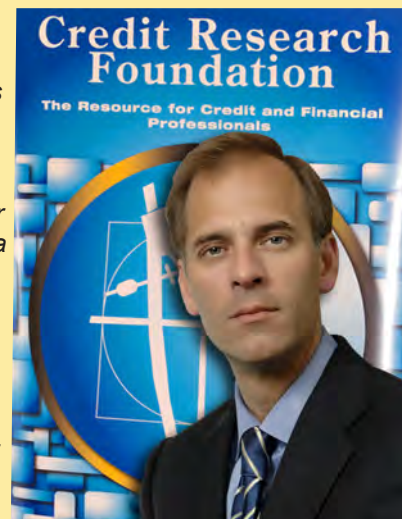
Normalizing monetary policy after a recession always engenders significant volatility in financial markets. This

time will be no different, and it is prudent to expect even more ups-and-downs in markets this time around given how far from normal the Fed is starting. It is thus not too much of a stretch to construct a scenario in which markets go badly off the rails and take the expansion with it. Yet, under most scenarios the economy should be able to weather the wrath of financial markets with reasonable grace.

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools.

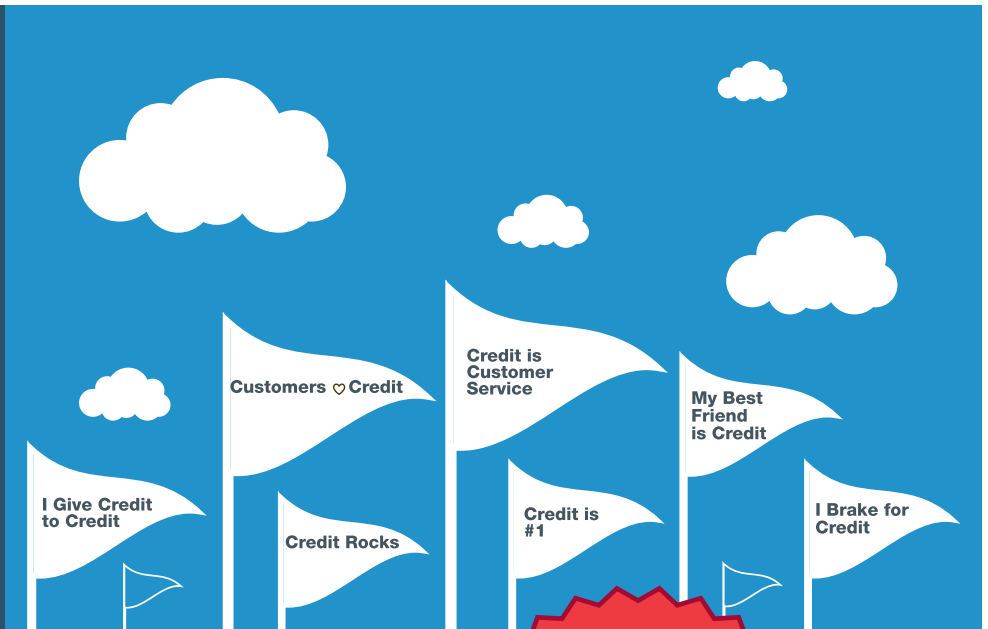
Dr. Zandi is a co-founder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations, and policymakers at all levels. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, CNN, Meet the Press, and various other national networks and news programs.





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Hurts So Good – US Supreme Court Rejects Attorneys’ Fees in Chapter 11

By: David H. Conaway
Shumaker, Loop & Kendrick, LLP

Atakeaway from a recent Supreme Court Decision is the necessity to include an attorneys’ fees provision in a contract in the event legal fees are incurred in enforcing the contract.

On June 15, 2015, the US Supreme Court ruled that a law firm could not recover fees it incurred in defending its own fee application.

THE ASARCO CASE

The case involved the copper company ASARCO LLC that filed for Chapter 11 protection in 2005 to deal with cash flow and environmental issues, among others.

ASARCO retained Baker Botts (“law firm”) to represent it in the Chapter 11 case. Among other services, the law firm pursued fraudulent transfer claims against ASARCO’s parent, obtaining a judgment for \$7 billion—\$10 billion, arising from the parent’s forced sale of another subsidiary.

The judgment facilitated a successful Chapter 11 reorganization, where creditors were paid in full.

The law firm filed a fee application for \$120 million, and the parent-controlled debtor objected to the fees. The Bankruptcy Court overruled the Debtor’s objections and approved the law firm’s fee application, as well as \$5 million in fees incurred defending the law firm’s fee application.

On appeal, the District Court affirmed the approval of the law firm’s fee application. However, the Court reversed approval of the \$5 million of fees for defending the fee application.

The US Supreme Court agreed.

TAKEAWAYS

The ruling no doubt evokes a visceral satisfaction as fees in Chapter 11 cases have come under fire recently as often disproportionately high compared to the value generated for the estate. However, the facts of the ASARCO case indicate that the value generated for the estate was substantial, apparently a multiple of the fees incurred.

The US Supreme Court’s ruling was based on and highlights the “American Rule” regarding legal fees, that litigants shall be responsible for their own legal fees, unless a statute or a contract provision shifts the risk to one party. For example, most states have adopted

some form of an unfair and deceptive trade practices statute, which normally provides for the plaintiff to recover attorneys’ fees for pursuing such claims from the defendant, as well as damages.

It is also common for commercial contracts (including sales contracts, loan agreements, license agreements, leases, etc.) to contain a provision shifting the responsibility for attorneys’ fees to the party who breaches a contract. For example, a commercial sales contract often provides:

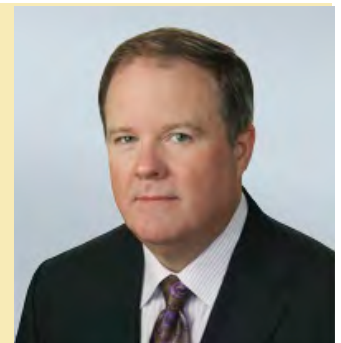
in the event this contract or the obligations of the buyer in the contract must be enforced against the buyer, the seller may recover its reasonable attorneys’ fees from the buyer.

State and Federal courts generally enforce such provisions against a buyer without hesitation.

Shifting responsibility for attorneys’ fees can have material impact on litigation and the incentives of the parties involved in litigation. If a buyer in a commercial sales contract knows that it will be liable for not only the obligation owed to the seller for goods or services sold or provided, but also for the seller’s attorneys’ fees (especially when coupled with a robust default interest), the buyer has incentive to resolve the litigation. Merely asserting defenses to delay payment of obligations owed will cost the buyer if it is responsible for the seller’s attorneys’ fees, not to mention its own attorneys’ fees.

In the competitive global business environment, companies are challenged to deliver value to stakeholders. Minimizing risks and shifting costs where possible helps this challenge. It is prudent for companies to maximize the business opportunities presented by the “American Rule” by reviewing their contracts to ensure appropriate attorneys’ fees provisions are included.

David H. Conaway’s principal areas of practice are bankruptcy (primarily Chapter 11 proceedings), non-bankruptcy insolvencies or restructurings, workouts, commercial transactions, and international transactions, disputes and insolvencies.





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Watch your email for news about more webinars on relevant and trending topics that will be offered **free of charge** in the coming months.



The Chinese Currency Devaluation: What Does it Mean?

Steven C. Isberg, Ph.D
CRF Sr Research Fellow

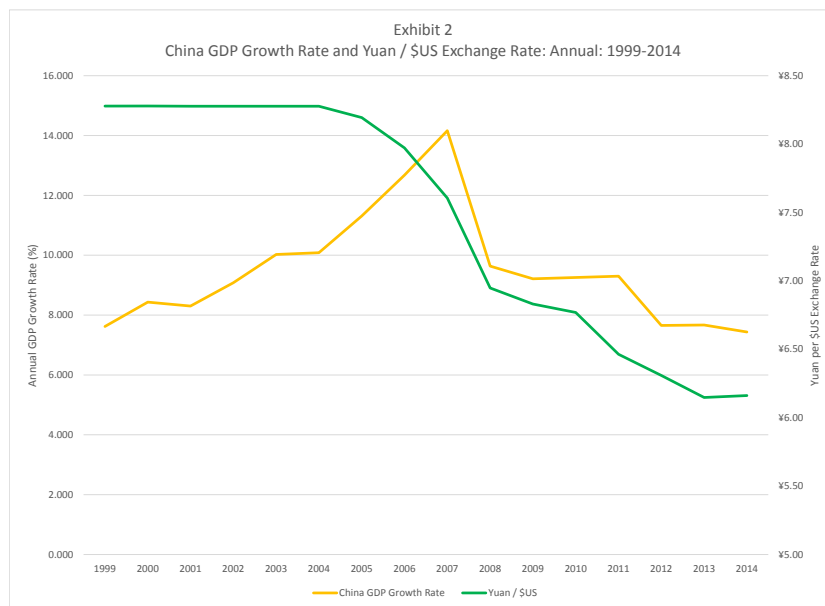
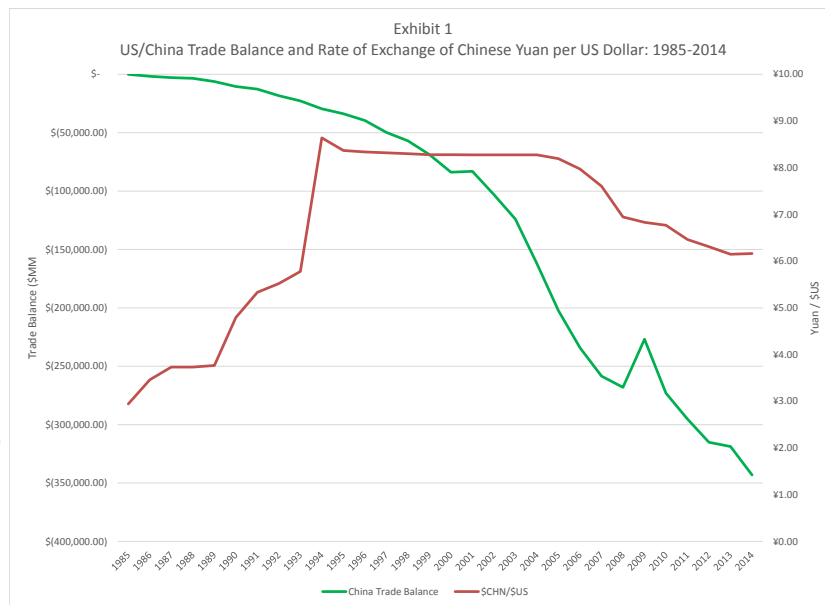
Exactly what is behind China's recent decision to devalue its currency, thus weakening it relative to the currencies of its major trading partners? How has or will it affect the US and world economies? The markets seemed to have recovered from their initial reaction to the move, but will there be longer term repercussions?

The central bank of China moved to devalue its currency, the yuan (or renminbi) by at least two percent this past August, thus deliberately weakening the yuan relative to the currencies of its major trading partners. Global equity markets moved dramatically in response, calling into question the sustainability of their underlying asset values.

China's decision can be viewed as defensive in the sense that it is attempting to keep its rate of annual economic growth from falling further than it has in the past two years. The decision may also be viewed as a more offensive, preemptive strike against a potential move on the part of the Federal Reserve to increase US interest rates. As we witnessed September 17, 2015, the Fed held off on any increase in interest rates for the time being, in spite of the expectation that the discount rate would be increased by as many as 25 to 40 basis points.

China's manipulation of its currency value has had a huge impact on global trade patterns, and has led to the persistent and deepening imbalance of trade with the US. As can be seen in **Exhibit 1**, China began these moves back in the late 1980's, with the final and most significant

of the devaluations occurring in 1993-94. For the following 11 years, China pegged its currency's exchange rate to that of the US dollar, contributing to a trade imbalance that grew into a US trade deficit of over \$268 billion by the year 2007. In spite of China's allowing its currency to increase in strength between 2005 and the end of 2014, that trade gap widened with only a slight turn during the year immediately following the collapse of the credit markets in 2008.



The rising strength of the yuan, however, has corresponded to a declining annual growth rate in China's GDP. As can be seen in **Exhibit 2**, the growth rate reached a high of over 14% in 2007, and has since fallen to less than 7.5%. In response, the Chinese central bank has been reducing interest rates and pursuing monetary stimulus efforts similar to the quantitative easing pursued by the Fed following the credit market collapse and recession in 2009. Reversing the declining trend in its economic

Exhibit 3: U.S. Trade Balances with China by Industry			
General Industry Description	Exports (\$000)	Imports (\$000)	Net Balance (\$000)
Food and live animals	\$ 7,279,097	\$ 5,964,467	\$ 1,314,630
Beverages and tobacco	\$ 336,512	\$ 70,114	\$ 266,399
Crude materials, inedible, except fuels	\$ 31,033,496	\$ 2,236,356	\$ 28,797,141
Mineral fuels, lubricants and related materials	\$ 1,770,490	\$ 444,103	\$ 1,326,387
Animal and vegetable oils, fats and waxes	\$ 161,007	\$ 50,889	\$ 110,118
Chemicals and related products, n.e.s.	\$ 13,745,934	\$ 16,512,756	\$ (2,766,822)
Manufactured goods classified chiefly by material	\$ 6,404,186	\$ 54,491,461	\$ (48,087,275)
Machinery and transport equipment	\$ 52,700,078	\$ 246,331,217	\$ (193,631,139)
Miscellaneous manufactured articles	\$ 8,854,652	\$ 145,878,887	\$ (137,024,235)
Commodities and transactions not classified elsewhere	\$ 1,390,216	\$ 4,574,548	\$ (3,184,332)
Total	\$ 123,675,667	\$ 476,554,797	\$ (352,879,130)

Source: U.S. Census Bureau

growth rate is most likely the major element of its intentional effort to devalue its currency.

An interesting question regarding this move is whether it was also intended to preempt the Fed from raising US interest rates. Such an increase in US rates may actually serve to benefit its trading partners by strengthening the US dollar. Rising interest rates increase the investment value of a currency and may serve to increase the demand for, and thus, the value of that currency. A higher valued US dollar would lead to increasing imports on the part of the US, and contribute to sustaining the trade imbalance with China, benefitting the latter at the expense of US exporters.

When one nation pegs its exchange rate to the currency of another, it also implicitly creates an interdependent monetary policy with that nation. As the Fed engaged in quantitative easing and increased the monetary base between 2008 and 2014, China implicitly did the same. Under a system of floating exchange rates, expansion of the supply of US dollars relative to the yuan would weaken the dollar and strengthen the yuan. When the exchange rate is pegged, however, the supply of yuan implicitly increases along with the supply of dollars. This is one factor that has served to keep the trade imbalance in place for the past twenty years. There is a downside, however, if the US monetary authorities reverse this path.

If the Fed were to increase interest rates, the dollar would tend to strengthen in the global markets. While the exchange rate peg would hold the value of the dollar relatively constant to the yuan, the Chinese would experience increasing difficulty in keeping the yuan from strengthening relative to the currencies of its other trading partners, and thus, may serve to reduce its exports to those nations. Preempting the Fed's move to increase rates would serve to China's benefit in this regard.

Another concern regarding an increase in US rates is whether such an increase would cause the US economy to slow down. While advocates of a rate increase point to falling unemployment as a sign that inflation may be on the horizon, such inflation has not appeared. Rather, inflation appears to be slowing in many parts of the US economy. If

there is an underlying weakness in the US economy, and there very well may be such a weakness, an increase in rates could result in a spontaneous end to the supposed economic recovery of the past few years. This would have a negative impact on China's exports to the US.

The main impact of the devaluation on the US economy will be persistence of the ever-growing trade deficit with China. The US ran an overall trade deficit of just over \$508 billion in 2014. At over \$343 billion, the individual trade deficit with China represents over 67% of that total. The next largest component is the \$142 billion deficit with the European Union, much of which is, at least in part, explained by the strengthening of the dollar relative to the Euro in response to the debt crises plaguing the latter currency over the past few years. China and the EU together make up almost 96% of the overall US trade deficit. With annual exports of over \$2.34 trillion, the US remains the world's largest exporter, but the Chinese devaluation will have an impact on that number's growth.

"The main impact of the (Chinese Currency) devaluation on the US economy will be persistence of the ever-growing trade deficit with China."
Steven Isberg

The short- and long-term impacts on American businesses depend upon the relationships between those firms and China. For companies that rely on China as an outsource provider

of manufacturing and/or other business services, the weakened yuan will have a positive impact on profitability, and will encourage the movement of more manufacturing and services into that nation. Those companies importing raw materials and/or component parts from China will also benefit from the weakened yuan. The tendency to outsource and/or import raw materials and component parts will have a negative impact on the growth and development of US domestic providers of those goods and services, and could result in a slowdown in an economy that has recently grown, but not in a stellar fashion.

For any company exporting to China, the devaluation will also have a negative impact, as their goods and services will be more expensive to the Chinese. This will also result in a slowing of US economy growth.

The breakdown of the US trade deficit with China by industry, shown in **Exhibit 3**, provides a basis for forming

an expectation for the impact on those industries. In any case where the US runs a surplus at that industry level, the surplus will most likely fall. Where the US runs a deficit, that deficit will most likely increase. Companies and retailers that import from those Chinese sectors will be the principle domestic benefactors of the devaluation.

Expectations from Chinese Currency Devaluation

US consumers may see a benefit in terms of lower prices or fewer price increases on goods, either manufactured in China or those that use raw materials and components imported from that nation. It is doubtful, however, that this would offset the net cost of lower growth rates in the availability of domestic employment opportunities, particularly in the lower skilled areas and in manufacturing, both of which would be hurt by the devaluation. For companies, as mentioned above, the benefits and costs will depend on their business relationships with China.

About the author:

Steven C. Isberg is currently Associate Professor of Finance. He teaches graduate and undergraduate courses in corporate finance, financial analysis and valuation, and financial economic history.

In his role as Sr Research Fellow at the Credit Research Foundation he conducts various research studies and delivers online financial analysis courses as part of the CRF Online Classroom™ program. Dr. Isberg has over 25 publications in academic and professional journals and has served as a professional business consultant to a variety of firms. He frequently appears or is quoted in television, radio, and print media on financial and economic issues.



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New York Appellate Court Finds Ban On Credit Card Surcharging Constitutional: What It Means To The Credit Team And A Nationwide Surcharge Rollout

By Scott Blakeley, Esq. and Ruth Fagan, Esq. of Blakeley LLP

On September 29, 2015, the U.S. Court of Appeals for the Second Circuit vacated the earlier decision of the U.S. District Court for the Southern District of New York (SDNY), that had declared New York's anti-surcharge law (General Business Law § 518) a violation of the First Amendment and unconstitutionally vague. As a result of the Second Circuit's decision, the ban on surcharging credit cards, once more, will be enforceable in New York. What does the Appeals Court's ruling mean to suppliers' right to surcharge, as recently provided by the card networks under their rule changes, to New York businesses in the B2B space?

Background

Enacted in 1984, New York's anti-surcharge law prohibits sellers from imposing a surcharge on customers who use credit cards in lieu of paying by check, cash or other payment forms. In 2013, five New York businesses and their owners sued New York challenging the anti-surcharge statute, claiming that it violates the First Amendment's Free Speech Clause and is void for vagueness under the Fourteenth Amendment's Due Process Clause. In December 2013, the district court agreed with the Plaintiffs on both counts and entered a final judgment declaring New York's anti-surcharge statute unconstitutional and enjoining New York from enforcing the law against the Plaintiffs.

Context

The 2013 district court decision marked another victory for merchants, including suppliers, on the heels of a settlement earlier in the year through which Visa and MasterCard agreed to allow vendors to surcharge in the 40 states that had no local ban on the practice in place. In March 2015, a federal district court in California followed the NY district court's lead in finding that the equivalent California state legislation banning surcharges was also unconstitutional.

Ruling

The Second Circuit focuses more on how surcharging is labelled, rather than the implications of the fee or its cost to merchants and consumers. The Plaintiffs made three arguments in their appeal: that the NY statute prevented them from posting a "single price" for goods or services with a notation that credit card transactions are more expensive amounting to a violation of their First Amendment rights;

Expressions Hair Design feared posting two different prices showing a separate price for credit card transactions was a breach of the ban and therefore, a violation of its freedom of speech; finally, the Plaintiffs argued the ban was unconstitutionally vague.

The Second Circuit determined that prices set by retailers are not "speech", therefore, the First Amendment was not relevant. The Court stated that "all that [anti-surcharge statute] prohibits is a specific relationship between two prices, it does not regulate speech." In relation to the final two arguments of the Plaintiffs, the Court found that the parties did not cite a single New York authority interpreting the scope of the prohibition. In perhaps an opinion that some may consider shirking its core responsibility to decide the issues before it, the Court declared that the "dearth of authority dooms both of Plaintiffs' remaining challenges."

What It Means to the Supplier and a Surcharge Rollout

Note that not one of the 40 states that have not enacted anti-surcharge legislation has surcharge legislation pending. Moreover, the New York decision and laws may be interpreted to still allow surcharging in the B2B space. Suppliers should consider adopting a contractual waiver and choice of law provision in their card payment agreement form, whereby customers consent to waive the application of the surcharge prohibition to pay the supplier's invoice by credit card.

About the Authors ...

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CRF EXPO in Seattle - A Big Success



The CRF Team wishes to thank everyone that recently participated in our August Forum and EXPO!!!! It was held in Seattle this year and was the first 'visit' back to the Northwest in some time. As those who attended know, CRF enjoyed record-setting attendance and attendees had an opportunity to participate in the largest Trade Credit and Accounts Receivable Exposition in the country – with sixty-one (61) quality exhibitors and a waiting list of fifteen (15) more. Feedback to TEAM CRF was very gracious and positive. In turn, the Foundation thanked those in attendance for the energy and passion they brought to the event.

There were several first-time exhibitors in the mix of service providers. One of them was the International Association of Commercial Collection (IACC). Rande Frazee, one of the Board members from the organization worked at the IACC booth. He offered those he engaged with that the primary mission of the organization is to improve and support the business operations of its members - commercial collection agencies – and thus the practices and results for

practitioners. As for the CRF EXPO he said, "It's a great opportunity to get our message out there. CRF did a great job to try to guide the attendees into the Exhibitor hall."

Another first time exhibitor was Arthur J. Gallagher & Company's Marc Wagman, Area Executive VP of the firm. Mr. Wagman and Gallagher are brokers of credit and political risk insurance. Mr. Wagman enjoyed being able to personally meet EXPO attendees. "I walked away with the impression that the greatest opportunity for me is the networking and private discussions," he said.

Exhibitors at large stated that they look forward to next year's Forum & EXPO which is anticipated to be another record-breaking event. It will be held in Chicago, August 8-10, 2016. More information will be forthcoming, but there is no better way to investigate and understand what opportunities exist to support your business needs than a CRF Exposition & Forum.

Scenes from CRF Forum & EXPO
Seattle - August 10-12, 2015



Photos by Tom Diana

Thank You!

From the Credit Research Foundation to:



ABC-Amega, for sponsoring the featured speaker, Scott Hunter, at the CRF Forum & EXPO in Seattle, August 10-12, 2015



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This survey ends Friday, October 30th. Your **FREE** report will be sent out the first week of November 2015.

Platinum Partner Perspectives

This section highlights newsworthy events and corporate announcements from CRF's Platinum Partners



ABC-Amega Inc. has some big news to share: They are growing and moving.

Beginning September 8, 2015, ABC-Amega's corporate headquarters and operational center moved into a landmark building (see photo) in Buffalo, New York's historic Hydraulics District.

Their new address is:

ABC-Amega, Inc.
500 Seneca Street
Suite 400
Buffalo, NY 14204-1963



Their main number, as well as the direct numbers you currently use to reach ABC-Amega team members, will remain the same.

The ABC-Amega staff is looking forward to working in their new office environment.



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New & Returning CRF Members



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