American Bankruptcy Institute
Commission to Study the Reform of Chapter 11
Testimony of Kathleen Tomlin, CCE
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Good afternoon. I would like to begin by thanking the Commission for giving me an opportunity to provide testimony about preferences and creditors' committees from the perspective of an experienced credit professional. My name is Kathy Tomlin and I have worked in the credit industry for more than 27 years, am a long time member of and past-National Chair of NACM and have dealt with more than a few preference demands and cases.

I am employed as regional credit manager for Central Concrete Supply Co., Inc, a prominent building materials supplier located in Northern California, a U.S. Concrete company. Prior to joining Central, I also was employed for 26 years by Hanson Permanente Cement and Hanson Aggregates, serving as regional credit manager before relocation of the credit function out of the area. I obtained an MBA from St. Mary's College and earned the designation of Certified Credit Executive in 1998. I am also a graduate of NACM's Graduate School of Credit & Financial Management, a recent recipient of one of highest honors within the credit industry, NACM's O.D. Glaus Credit Executive of Distinction Award, and have provided expert witness testimony for credit related issues in litigation.

My role as credit manager is always to maximize my recovery on collection matters, including defending my company against preference claims. We have systems in place internally to help us react quickly when customers begin to show signs of financial distress, or a bankruptcy is filed. As part of my speaking and educational activities for NACM, other credit organizations and my own company, I often teach credit managers at all experience levels about the perils of bankruptcy, its short-notice periods and the various aspects of preference law.

Defending against preference demands is a time-consuming and expensive exercise. Many credit professionals are confused by the preference statute, particularly the various defenses available to creditors. All of us, no matter what level of experience we may have, are frustrated by the time and cost required to sort out the merits of a preference demand and evaluate our defenses.

The mechanics of putting together a preference defense are confusing to some credit managers and exasperating to all of us. We must examine the books and records which established the relationship, the payment history, any defaults in payment, all notes regarding communications with the customer and any notes, liens or security interests of any kind that may have been granted at the outset or during the course of the relationship. Unique to my situation, because my company is in the construction industry, I must review and evaluate the benefits of mechanic's liens, determine whether appropriate notices were given and look to see if there were are any bonds in place. Because most of my bankruptcy experience involves real property or bond claims or deal with a bankrupt developer, I often have several defenses against a preference demand, but still have to endure the time and expense of proving that defense to a trustee or debtor.

When there is no lien or bond in place, our defenses are generally the new value and/or the ordinary course of business defenses. To put together the information needed to prove these defenses requires great time and effort on the part of my staff, as well as employing one or more lawyers to advise us as to the standards applicable to such defenses in the districts in which the demand is made or the lawsuit is filed. Given the staff reductions and hiring freezes in effect in the credit departments of many companies, it can be difficult to dedicate the resources necessary to develop the information needed by counsel to adequately defend the preference in any particular jurisdiction.

For my part, to help prepare our defense as to ordinary course, I depend upon my industry credit groups to help to determine a pattern of payments in the industry. That information is helpful but not always definitive because every job is so varied, depending upon whether it is a commercial, residential, or mixed-use project. Often that information is not enough due to the requirements of the district in which the case is filed, and we are forced to hire an outside expert to review our books and records, evaluate the case, research the industry to the extent possible and testify on our behalf in court.

During this extended downturn in the economy, it seems to me that we have received more preference demands than ever. Fortunately, because my company is diligent about exercising lien and stop notice rights, we have been very successful in asserting our defenses and managing the credit before a bankruptcy is filed. As a consequence, we are frequently paid in full or at least on a current basis before the filing. Often, it is prior to the start of the preference period.

Even though my company has had success in asserting lien rights and getting paid outside of the preference period, or, defending preferences based upon the liens, the new value or the ordinary course defense, the fear of being sued always colors our analysis of any given credit situation and adds to the costs of collecting from financially distressed companies. Due to the ever-present fear of preference liability, we are often reluctant to extend additional credit or stretch out payments from a customer, even if we believe a company's distress is temporary, simply because we want to avoid the time and expense of a preference action. This uncertainty is not helpful to our company or our customers, and I firmly believe it drives up the costs of credit by a significant amount.

It is also distressing that we can be sued in locations like New York and Delaware, which are generally far from our location as well as from the business location of the customer. Defending preference demands in those locations often requires us to employ multiple lawyers in several areas just to appear in court and take any action. As a result, some companies agree to pay all or a portion of a preference demand simply to avoid the high costs of defending against a preference claim, which often exceed the amount of preference liability in controversy. While this willingness to settle may seem to provide a gain for that particular case, it is, at best, a short-term advantage. In the long term, the effect is to reduce the availability of unsecured credit and the options available to financially distressed customers.

As an experienced credit manager, I would like to see several changes in the preference statute. First, there should be imposed an obligation upon trustees and debtors to evaluate preference claims and defenses before any demand is made to creditors to repay an alleged preferential transfer. Also, there should be a cost/benefit analysis required that shows that pursuing such preferences would provide an actual benefit to the unsecured creditors of the estate above the cost to pursue the actions, with none of the preference recoveries earmarked for secured creditors. All too often, we discover the cost of commencing the preference actions is inordinately large when compared to the recoveries.

Third, the statute should be changed to afford more protections and defenses to creditors, with the goal of reducing the expense of responding to preference demands, and making the burden of proving those defenses consistent among the bankruptcy courts across the country. There should be no need to hire a third-party credit professional to testify about ordinary course. Instead, the testimony of the credit manager familiar with the case and the industry should be able to testify about industry norms and customs. If the debtor or trustee disagrees, the burden should fall upon them to hire an expert to contest the testimony of the credit manager. Additionally, trustees should not be able to sue just based on a review of the check register.

Fourth, there should be further changes in the law to eliminate the need for credit managers to travel to popular venues, often across the country, and hire several sets of lawyers to deal with a preference demand or defend a lawsuit, especially with regard to small preference demand amounts. Generally speaking, any preference claim less than $100,000, filed in New York or Delaware, is prohibitively expensive to defend when the vendor is located in a jurisdiction like California. It is critical that some protections be given to unsecured creditors to lower the cost of these cases. These changes would reduce some of the uncertainty inherent in dealing with distressed customers and perhaps reduce some of the costs of underwriting unsecured credit, thereby assisting both unsecured vendors and their customers.

I would also like to address the concept of creditors' committees. Committees provide a valuable service to unsecured creditors. They afford us an opportunity to a look under the tent, a way of participating in the case and obtaining information and a seat at the table otherwise denied to unsecured creditors. Like anything, there will be some committees that are not as effective as others, but the members generally try to look out for the greater good, and it would be a significant loss for unsecured creditors should the role of committees be reduced or eliminated.

I have served on several creditors' committees. Because the committees were formed, we were able to actively participate in the Chapter 11 process and work to maximize the recoveries of unsecured creditors. In one case, a liquidating Chapter 11, due to the efforts of the committee, we were able to realize an 80% recovery. There, the committee took over the marketing efforts of property the debtor had been unable to sell -- the result was a substantial improvement over the initial projections of payments to unsecured creditors. That experience is replayed in court after court throughout the country every day.

Likewise, the committee is often charged with examining transactions between the debtor and lender, the debtor and equity participants and other related parties. The committee frequently brings value to the case by pursuing available causes of action against insiders. Similarly, the committee is able to review potential preference issues and have a say on how such preference actions may be pursued or preserved for later review.

In one particular instance, the debtor had been a member of our Industry Credit Group, as well as a customer of my company. As a result, the unsecured creditors' committee knew what their pattern of payments had been to other creditors during the preference period, and for a significant period before the case was filed. The debtor's pattern of payments to vendors wavered by only a day or two over the course of the two to three years before the bankruptcy case was filed, and virtually all vendors were paid on the same time schedule. Due to this intimate knowledge of the debtor's payment history, the creditors' committee was not required to spend a great deal of time, efforts and funds to perform an all-encompassing preference claim review. In addition, because we were able to show this pattern to the debtor, none of the vendors were sued for preference recovery. In contrast, however, payments made to reduce obligations incurred by the debtor in the form of personal loans made to the debtor corporation by its principals showed a vastly different pattern. Only sporadic, minimal payments were made to the principals prior to the debtor's bank notifying the debtor that the bank "no longer wanted to be in the construction industry and lines of credit would not be renewed." Subsequent to that comment, the debtor began to make regular, substantial payments to the principals on the insider loans. After a demand was made by the creditors' committee, the funds were returned to the debtor's estate, because the principals were not able to prevail on any defense, including payments in the ordinary course.

I have been involved in many discussions about participating on creditors' committees by professionals in various industries. Each one believed the experience was an invaluable learning tool which afforded them a deeper understanding of the Chapter 11 process and a better understanding of how to maximize their recoveries, as well as generally providing a better outcome for unsecured creditors in the case at hand. Unsecured creditors provide goods and services on an unsecured basis to companies across all industry types throughout the United States. The importance of our contribution to the continued improvement in the economy cannot be overstated.

In conclusion, we strongly believe that the Commission should include preference recommendations designed to reduce the costs of underwriting unsecured credit by changing the law applicable to preferences by making the defenses uniform, easier and less expensive to prove, to eliminate the need to respond to preference demands in courts far from our primary locations and to require debtors and trustees to review potential preference defenses and conduct a cost/benefit analysis before making such demands. Such measures would greatly reduce the cost and uncertainty that now exists in underwriting unsecured credit.

Thank you for your time this morning. I would be happy to answer any questions the esteemed members of the Commission have.