American Bankruptcy Institute
Commission to Study the Reform of Chapter 11
Testimony of Thomas Demovic, CCE, ICCE
Senior Manager, Corporate Credit Department
Sharp Electronics Corporation

My name is Thomas Demovic. Thank you for giving me the opportunity to speak on this issue today. I am the senior manager of the Corporate Credit Department for Sharp Electronics Corporation. I previously held corporate credit positions with Unilever, Houbigant and L'oreal Products. I have been engaged in corporate credit for 42 years, obtained my Bachelors degree from Wilkes College, a Masters in Business Administration from Fairleigh Dickinson University, and the designation of Certified Credit Executive, which is the highest accreditation granted by NACM. I also hold the designation of International Certified Credit Executive from FCIB and graduated from NACM's Graduate School for Credit and Financial Management at Dartmouth College.

Sharp Electronics has been involved with numerous preference matters over the years and I'm here today, as part of the credit department, having worked on many of those matters. Any remarks that I make today are my own opinions based on my own experiences, and in no way are they meant to represent an official statement from Sharp Electronics. With that said, the focus of my remarks today will be the Ordinary Course of Business Defense.

The Electronics' Industry is Unique

Sharp does not merely manufacture goods and sell them to an end-user. To the contrary, most of our customers are distributors of Sharp product. This creates an entirely unique relationship between Sharp and its customer.

In my prior industry, the company sold products, usually on 30-day terms. If a customer did not pay on time, it was easy to place that customer on credit hold or stop selling to that customer all together. You can't do this in a business with distributors for a number of reasons. First, there are often distributor agreements which require Sharp to supply specific product and also designate a particular customer to be an “authorized dealer” of Sharp merchandise. And even where there is no formal distributor agreement, there are dealers that Sharp recognizes as “authorized” with various programs that affect the way that dealer pays its bills.

Some of these programs include rebates and discounts. More importantly, some of the programs involve how and when merchandise can be returned to Sharp and when a bill’s payment will be delayed because of returns, claims for discounts, charge backs, etc.

It is not uncommon for an invoice with 45-day terms to be paid much later because of these types of issues. When preparing an “ordinary course of business” analysis and needing to defend against a preference action, I often have to deal with an outsider who has no knowledge of, and frankly, doesn’t care about how our industry works. That outsider is merely trying to collect as much money as possible.

Ordinary Course of Business Defense

Personally, I have been involved with numerous preference actions. They are not straightforward. Our industry is unique in that there are numerous terms of sale that are used with any one customer. In one specific case, our customer was given 30-, 45-, 60- and 75-day terms, depending on what type of product was being purchased and where the product was coming from. A subsequent preference lawsuit totaled $35 million. The liquidating trustee conceded that $20 million was for product purchased on a “cash in advance” basis and agreed that such $20 million would not be sought as a preference. However, the trustee believed it had a solid complaint for the remainder. Additionally, the lawsuit contained a demand for $3 million in alleged receivables from Sharp due to rebates, discounts and so on.

I worked with our law firm and a preference analyst, and the spreadsheet that was created showed that payments made during the year prior to the Chapter 11 proceeding generally ranged from 60 days to 90 days. And, there were a few anomalies of substantially later payments due to disputes or shortages. The preference period payments really didn't change, yet there was a serious spread in payments. Even using, not a percentage, but a flat amount of days as a spread, the payments were disparate enough that a settlement could not be reached. Therefore, using a simple 10-day spread did not accurately portray how business was conducted. Fortunately, separating out the invoices paid according to the invoice terms created an interesting result. It turned out that the 30-day invoices were paid the slowest, and we believed that to be due to the type of product which was sold under those terms. However, the 45-day term invoices were paid on average within 53 days. The 60-day term invoices (which were the majority of the invoices involved) were paid on average within 83 days. The 75-day term invoices were paid on average within 91 days. A different calculation had to be used for each different set of terms. Effectively, the invoices and payments were broken into four separate categories, so four separate sets of analyses had to be prepared in order to prove that the hypothesis would work showing that there was a different yet ordinary average paid dates for each different set of terms.

Ultimately, the entire lawsuit was settled by a payment much, much lower than initially sought after about one year. An expert witness brought in by Sharp to help defend this lawsuit cost the company thousands of dollars in fees. It had to have cost the Debtor an equal amount of money. The real question is: how much, if anything, of that sum would ever go to the unsecured creditors? It is this kind of example that makes the current preference statute so troubling.

The Debtor absolutely knew that its payments to Sharp were different because the payment terms differed. An accurate and complete analysis, not just of new value, but of the ordinary course of business should have been done before the lawsuit was commenced. I believe, however, the Debtor was guided by counsel who saw a $35 million opportunity and decided to move forward without determining what the actual net realizable amount could be.

In another, quite different case, Sharp was sued to recover the sum of $27,734 in alleged preferences. It barely made any sense to pay a large legal bill to deal with this preference. However, it could not be ignored. This Debtor assumed Sharp's executory contract upon confirmation of its plan. As such, all pre-petition payments owed to Sharp had to be paid in full. Therefore, any pre-petition invoices that were paid by the Debtor would have been paid anyway due to the assumption of the executory contract.

The Litigation Trustee insisted that the payments made before the executory contract was assumed were recoverable as preferences. It was economically unfeasible to spend a lot of money on legal fees to prove or disprove the Litigation Trustee's hypothesis. And, I would have spent more money running an ordinary course of business analysis. The matter for nuisance value was settled and less than $2,000 was paid to the Litigation Trustee to do so.

Sharp had to pay thousands of dollars to defend these preference actions. I believe it is a common occurrence for an adversary proceeding to be commenced merely because it is believed that preference defendants will settle rather than spend the time and money defending such an action.

In my opinion a change to the preference statute is logical. I believe it should save bankruptcy estates and trade creditors an enormous amount of money. Before a trustee or debtor or creditors' committee wastes the time and energy in pursuing a preference from a trade creditor, that trustee, debtor or creditors' committee should do its homework.

A true preference analysis should be prepared to determine if, in fact, the payments made during the preference period were not ordinary.

Rather than the onus being on the trade credit grantor to defend against a preference, the burden should be on the debtor or creditors' committee or trustee to determine that the payments made were not in the ordinary course of business.

SUMMARY

Trade creditors have suffered enough loss in bankruptcy proceedings without having to pay back money which was paid in the normal course of business. In my opinion it is unfair to make the creditor prove what is ordinary. I think that the trustee, debtor or creditors' committee bringing the action should prove that the payments made during the 90 days prior to bankruptcy are not ordinary.