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## The Sole-Source Supplier: Working Through Your Key Customer's Financial Difficulties While Bettering Your Position For Payment On The Delinquent Account

Scott E. Blakeley, Esq.

Your company is a sole-source supplier with a multiyear supply contract with a customer, who is a significant source of business for your company. You are the sole sole-source supplier because of the uniqueness of your product or service. The supply contract was negotiated by sales and marketing when the customer was financially sound. A year into the contract, the customer's cash flow is negative and they have failed to honor the 30 day invoice terms. They blame a downturn in the economy as why they cannot pay according to invoices. The customer has placed additional orders, but needs the credit because of cash flow. Your credit research and evaluation indicates that the customer's cash flow problems are projected to last but two quarters (and, of course, confirmed by the sale's department), and may remain a significant source of business over the balance of the supply contract. The customer's cash flow problems result in the lender calling the loan in default. Your account is now 45 days past due.

You consider balancing alternatives for improving the quality of the delinquent account through a negotiated repayment agreement, yet working with the sale's force that the customer remains a meaningful source of revenue by honoring the orders. Your company, of course, does not want to lose the significant revenue generated by the customer, but likewise does not want to increase its credit exposure.

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## Does A Critical Vendor Lose Its New Value Defense To A Preference Action?

Bradley D. Blakeley, Esq.

If the vendor has a pre-petition claim and is selected as a critical vendor, does that vendor lose its new value defense for the invoices paid under the critical vendor order? B&B recently encountered the issue while defending a vendor in the Delaware bankruptcy court. Judge Sontchi decided the issue this week and the result is a big win for creditors.

**The Bankruptcy Preference Law**

The Bankruptcy Code vests the trustee with far reaching powers to avoid transfers and transactions prior to a bankruptcy filing. The power to avoid preferential transfers is out of the trustee's most potent weapons, and the Bankruptcy Code defines a preferential transfer expansively to include nearly every transfer by an insolvent debtor during the preference period. Vendors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. A debtor is deterred from

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### Special points of interest:

- Sole-Supplier
- Subsequent New Value Defense
- 503(b)(9) claim
- Recharacterization
- Delinquent Customers
- Preference Actions
- Second Chapter 11 Filings

### Inside this issue:

## Recent Developments Regarding Section 503(b)(9) Of The Bankruptcy Code

Ronald A. Clifford, Esq.

The case law continues to develop regarding Section 503(b)(9) of the Bankruptcy Code. Issues such as the conditions under which a 503(b)(9) claim may be paid prior to the effective date of a plan, and what constitutes a "good" under 503(b)(9) have been at the forefront of case law in recent years. Many of these issues remain unresolved at the national level, and what vendors are left with are varying decisions from different jurisdictions around the country.

One of the more interesting court decisions regarding 503(b)(9) was recently published by the Bankruptcy Court for the District of New Hampshire in a case titled *In re Momenta, Inc.*[1] The *Momenta* case touches upon two critical questions regarding 503(b)(9), which are: (1) may a vendor be allowed a 503(b)(9) claim when the goods are drop shipped directly to the debtor's customer by the vendor; and (2) may a 503(b)(9) claim be disallowed simply because a vendor received a preferential payment? The *Momenta* court answered each of these questions in the negative. The caveat to the *Momenta* court's ruling is that the opinion is currently on appeal. Consequently, the jury is still out on what the ultimate holding of this case will be. However, these two questions are often sources of litigation, and the *Momenta* court's opinion, along with the ways in which other bankruptcy courts across the country have decided these issues, makes this a topic worth vendors' attention.

To set the table, the vendor at issue in the *Momenta* case was a manufacturer of paper products based in China. A portion of the goods delivered by the vendor within the twenty days prior to the petition date were drop shipped by the vendor directly to the debtor's customer. The court record shows no evidence that the debtor was ever in physical contact with the goods that were drop shipped. This fact is important because 503(b)(9) clearly reads, in part, that a vendor is allowed and administrative expense priority claim for "the value of goods **<u>received by the debtor</u>** within" twenty days of the petition date. Many vendors ship goods to a customer through a third party carrier or house them with a third party intermediary for later pick-up by the customer. Under what circumstances does the debtor actually "receive" the goods for 503(b)(9) purposes?

Using the Uniform Commercial Code's definition of receipt under reclamation, bankruptcy courts have consistently held that "receipt" for 503(b)(9) purposes means physical receipt of the goods by the debtor. Placing the goods with a freight forwarder or warehouseman is not enough. Unless the debtor had the goods in hand within the twenty days preceding the petition date, there is no claim under 503(b)(9). This makes sense when one views the history of 503(b)(9). Congress crafted 503(b)(9) from the older reclamation statutes contained in the pre-2005 version of the bankruptcy code. Reclamation essentially allows a vendor to recapture goods that an insolvent customer is in possession of. Prior to an insolvent customer actually taking physical possession of a vendor's goods a vendor may be able to stop those goods in transit, refuse to ship the goods altogether or demand adequate assurance of performance. Following this logic, 503(b)(9), a reclamation based statute, deals with the point in time at which the goods have already reached the insolvent customer. So, it makes sense, following the aforementioned history of the statute, that 503(b)(9) only applies when a customer is in physical possession of the goods.

In the *Momenta* case, the debtor was never in possession of the goods that were drop shipped directly to the debtor's customers by the vendor, and so the vendor was denied a 503(b)(9) claim. A literal reading of 503(b)(9) and an understanding of its genesis would seem to justify this result. This is a crucial rule for those vendors that drop ship goods to third parties to understand.

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1. 455 B.R. 353 (Dist. NH 2011).

## Fear And *Lothian Oil*: Are Unsecured Creditors Under Greater Threat From Insider Loans?

Johnny White, Esq.

The controversial doctrine of recharacterization empowers bankruptcy courts to ignore the formal labels of a loan and, looking instead to a transaction's substance, reclassify a lender's claim as equity instead of debt. The primary goal of the doctrine is to stop shareholders retaining assets of a bankrupt estate at the expense of creditors simply by dressing up their capital investments as loans. Recharacterization can have significant impact on the treatment of unsecured creditors in many bankruptcies. Its practical consequence is that the newly recharacterized loans fall down the ladder of priority (below the trade creditors) in the scheme of distribution at the end of the case. In large Chapter 11 cases where the debtor is carrying millions, perhaps hundreds of millions, in mezzanine bond debt for example, relegating the bondholders could be the difference between zero and hundred cent dollars for the trade.

A recent decision from a federal appeals court in Texas on the topic of recharacterization – *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011) – piqued the interest of commentators for rejecting the rule that a lender must be an "insider" of the debtor before its debt can be recharacterized. Though this aspect of the decision is important, the attention has distracted somewhat from a more fundamental departure from precedent within the opinion – one bearing on the very source of authority for recharacterization. The court in *Lothian Oil* determined that state, as opposed to federal, law governs whether a debt should be recharacterized. If widely followed, this could have profound implications, as discussed below.

**How and When Recharacterization Can Be Invoked: A Split of Authority**

After *Lothian Oil*, a four-way split exists among federal circuits that have interpreted the place of recharacterization in the Bankruptcy Code. Whether this circuit split could be resolved by the U.S. Supreme Court and, if so, how, is far beyond the scope of this article. It suffices to say that the law is unsettled, and the Texas opinion, which is well-reasoned, could gain currency going forward.

The four approaches to recharacterization are:

1. Recharacterization is incompatible with the Bankruptcy Code and no longer exists;
2. Recharacterization is allowed where it is an insider loan and the company was undercapitalized to begin with, or when no disinterested lender would have made a comparable loan;
3. Recharacterization is allowed when the totality of the circumstances and terms of the loan reveal that it was intended as a capital contribution at the time it was made; or
4. Recharacterization of a loan is allowed where applicable state law authorizes recharacterization.

The first two approaches are minority approaches that have failed to win any widespread support.[1] The third approach, a case by case review of all the surrounding circumstances, has been favored by most courts. This test was imported from tax court decisions analyzing how transactions should be treated for tax purposes, and looks to a list of factors. The factors most commonly cited[2] are:

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"RECHARACTERIZATION CAN HAVE SIGNIFICANT IMPACT ON THE TREATMENT OF UNSECURED CREDITORS IN MANY BANKRUPTCIES."

## Must Trade Creditors Continue Doing Business With Delinquent Customers Who File Bankruptcy, And What Protections Are Available?

David Mannion, Esq.

The scenario is a familiar one. A vendor has a supply contract with a customer who is already in default. Then the customer files bankruptcy. The vendor doesn't want to face further exposure during the bankruptcy ("post-petition"), but is equally concerned about being sued for breaching the contract or violating the automatic stay. What are the vendor's rights?

In answering this question, the first step is to examine the terms of the contract to determine whether it is "executory" under § 365 of the bankruptcy code. If not, then the vendor has no contractual obligations to the customer (now the debtor). However, if the contract *is* executory then a vendor needs to tread extremely carefully. While a vendor cannot refuse to comply with the terms of an executory contract post-petition, there are cases that suggest unsecured trade creditors are entitled to insist on some protection, including cash in advance, in their post-petition dealings with debtors who already owe them money.

**A. What Makes A Contract "Executory" Under Section § 365 of the Bankruptcy Code?**

If a contract is deemed "executory" under § 365 of the Bankruptcy Code it may be assumed or assigned by the debtor – in other words, the debtor is free to keep or reject the contract. However, it can take a debtor several months or more after it files bankruptcy to decide whether to keep or reject a given contract. During this "limbo" period (post-petition but prior to assumption or rejection) a vendor is required to comply with the terms of an executory contract.[1]

So what makes a contract "executory?" According to the Third Circuit Court of Appeals, which sits in review of the Delaware bankruptcy courts, "unless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under § 365."[2] "The time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed."[3]

Applying this test properly can be a difficult task. For example, many supply contracts require a vendor to fulfill orders placed by a debtor throughout the duration of the contract. However, the contracts do not impose a *mutual* obligation on the debtor to place orders with the vendor. Even though the duration of such a contract might last several years beyond the date of the bankruptcy filing, the contract might not be executory since *both* parties may not have material unperformed obligations on the date of the bankruptcy.[4]

Nevertheless, where individual orders or "releases" have been issued under such a contract and have not been fulfilled on the date of the bankruptcy filing, those releases might be considered independent "executory" contractual obligations (since the vendor is obliged to fulfill the orders once they have been placed, and the debtor is under an obligation to pay for them.)[5]

By contrast, many supply contracts do not contain any provision defining the intended length of the contractual relationship. "[W]here no minimum duration is stated in a contract, the general rule is that it is terminable at will by either party."[6] The termination of such a supply relationship is not generally considered to be a breach of contract.[7]

**B. Assuming A Contract Is Executory Under § 365 of The Bankruptcy Code, What Protection Is Available To A Creditor Post-Petition?**

So assuming your contract is "executory," and your customer is already in default and then files for bankruptcy, are you required to continue doing business with them post-petition according to the terms of the contract? For example, if your contract is executory and requires you to supply goods on credit, does

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1. *See In re Nat'l Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) ("[M]ost courts agree that before an executory contract is assumed or rejected under §365(a), that contract continues to exist, enforceable by the debtor-in-possession, but not enforceable against the debtor-in-possession.") (*citing NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (U.S. 1984).)

2. *In re Exide Techs.*, 607 F.3d 957, 962 (3d Cir. 2010).

3. *Id.*

4. *See In re Exide Techs.*, *supra* at 962; *see also In re Riodizio, Inc.*, 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997) ("[A] prepetition contract is executory when *both* sides are still obligated to render substantial performance. *Where such performance remains due on only one side, the contract is non-executory*, and hence, neither assumable nor rejectable.") (emphasis added).

## Having The Tough Conversation With A New Preference Action Client And Some Initial Steps To Take

In my experience one of the toughest conversations a creditors' rights attorney can have with a client is the first time the client experiences a preference demand. Readers may recall the first time they received that demand letter in the mail or were served with a preference action complaint. You had a great long term relationship with a customer, providing goods or services on a regular basis. The customer told you they were having some financial troubles, but you stood by them providing them with needed goods or services. You did not even change the customary terms of your relationship. (Well, some of you probably did, which could impact some of the defenses you may have.) Finally, the customer did not pay the last couple invoices you sent them. You even felt bad for your customer when it called to tell you it had filed for bankruptcy. You chalked it up to a bad experience and promptly concentrated on your other paying customers. You had work to do and employees to pay, so you forgot about your old customer.

That is until 12 to 18 months later when you received the demand letter in the mail from the Bankruptcy Trustee, Debtor in Possession ("DIP") or Creditors' Committee (the "Committee") asking you to return the $20,000, $30,000, or $100,000 that you had been paid by your customer within the 90 days prior to the customer filing for bankruptcy (the "Preference Period"). I can only imagine the incredulous look on your face when you first received that letter. The thought process, "How can they ask for this money back? We earned this money!! This has to be some mistake. Margie, Get the attorney on the phone!"

Then you get us on the phone and we have the tough conversation. We have to explain to you that yes, the bankruptcy codes does allow the Trustee, DIP or Committee to demand return of any payments you received during the Preference Period. We have to explain that although you legitimately earned the money, there may have been similarly situated companies that were not paid any of what they were owed by your bankrupt customer. We have to explain to a capitalist the socialist purpose of the preference action is to have money paid by the bankrupt customer to any of its vendors, etc. during the Preference Period returned to the Bankruptcy Estate. You will receive an unsecured claim in the amount of any returned preference, unless otherwise waived. The Bankruptcy Estate is then redistributed pro-rata among all of the similarly situated creditors, after payment of all higher priority claims. You might even take comfort in the fact that, depending upon the size of the bankrupt customer, you are just one of thousands who received the demand letter. You are not alone in what amounts to be a large scale legal shake down.

Once you have passed through the "denial" stage of the process and arrive at the "acceptance" stage, then we can begin the real work of resolving the problem as quickly as possible with the least expense to you. According to the Bankruptcy Code, generally, the Trustee has two (2) years from the date of the bankruptcy petition to bring any preference action litigation. 11 U.S.C. Sec. 546(a). In the scenario painted above, we then have 6 to 12 months to resolve the demand letter prior to any litigation being filed against you. In most cases the demand letter you received will have an offer of settlement for a percentage of the amount you were paid by your customer during the Preference Period. What the Trustee is counting on is that you do not want to deal with the demand letter and will just send in a check to resolve it. Thankfully, you have chosen to contact your attorney, who, depending upon the facts, will be able to resolve the case for less than the initial settlement demand.

The good news is that the vast majority of Preference demands, even if they reach the level of litigation, never reach the inside of a courtroom. Aside from the elements of a preference which can be contested at the litigation stage, the Bankruptcy Code sets forth several

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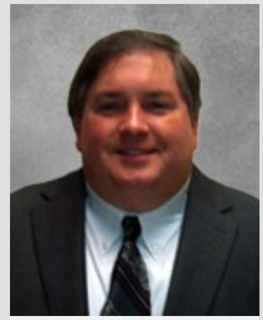

Peter M. Sweeney, Esq.

"WE HAVE TO EXPLAIN TO YOU THAT YES, THE BANKRUPTCY CODES DOES ALLOW THE TRUSTEE, DIP OR COMMITTEE TO DEMAND RETURN OF ANY PAYMENTS YOU RECEIVED DURING THE PREFERENCE PERIOD"

Scott E. Blakeley, Esq.

## Helping The Sale's Force Make The Sale To Your Customer Emerging From Chapter 11 – More Credit Risk Than The Score Reveals?

In a prolonged down economy, making the sale can be key to maintaining market share, even with customers that are struggling financially, even customers that have filed Chapter 11. The credit professional's role in facilitating a trade relationship has evolved to a relationship builder, whether at the new account stage, where the customer has defaulted on invoices to where the customer has filed Chapter 11 yet still wants your product or service on terms. In the Chapter 11 setting, after much negotiation with your chapter 11 customer, you have an allowed administrative claim for the invoice value of the goods the customer received within 20 days (the 503(b)(9) claim) of the Chapter 11 filing. Your major customer's Chapter 11 plan of reorganization is finally confirmed. To incentivize vendors selling to the customer as it exits Chapter 11 on credit terms, the debtor increases the distribution to vendors selling on normal terms. The customer's Chapter 11 exit strategy set forth in the plan is continued through operations. You contract to ship on credit to the "reorganized" debtor post-confirmation for one year in exchange for an increased distribution on your non-priority claim. Your trade relationship moves from invoice by invoice to post confirmation supply contract. Your sale's force and management anticipate resuming significant sales to the reorganized debtor and supports resumption of credit terms.

You consent to payment over time on your 503(b)(9) claim, based on the reorganized debtor's cash flow. Payment on a percentage of your mid-six figure non-priority claim is also to be over time.

Notwithstanding all of the projections prepared by the debtor's accountants to confirm the plan of reorganization demonstrating the debtor will be profitable, it is not. Revenue projections are missed and the debtor fails to pay on your b9 claim. The debtor also fails to pay on your post-confirmation credit sales. The debtor is chased by creditors and files a second Chapter 11 bankruptcy. Is a company eligible to file a second Chapter 11, also referred as a Chapter 22? Your major customer had spent two years in Chapter 11 and paid millions on its attorneys, accountants and investment bankers to assist in paring down creditors' pre-bankruptcy debts, disposing of assets and repositioning itself in the marketplace.

Your customer had circulated a hundred-plus page disclosure statement and plan of reorganization to its creditors, with statements in support by the creditors' committee and the bank group, coupled with pages of financial projections prepared by the debtor's financial advisor detailing how the "new and improved" reorganized debtor would meet its trade obligations and return to profitability. Of course, those are magic words to the sale's force. The bankruptcy court found the plan of reorganization "feasible" and confirmed the plan and the debtor's emergence from Chapter 11. You now realize that a confirmed Chapter 11 plan of reorganization, even supported with detailed projections showing your customer profitable, does not guarantee payment on your pre-Chapter 11 debts nor on your recent shipments on credit.

The most recent companies to make headlines with a second Chapter 11 filing are Filene's Basement/Sym's, Anchor Blue, Jackson Green LLC, and Constar International.

Many of these reorganized debtors forced to file a second Chapter 11 are mired in industries with strong competition, and could not meet their debt obligations and were forced into Chapter 11 again by their creditors. Notwithstanding years in Chapter 11, the extraordinary benefit of not paying pre-bankruptcy creditors, and a negotiated plan of reorganization that was supported by detailed projections of how the reorganized debtor would be profitable, such companies often failed to pare down their debt sufficiently in the first Chapter 11, or failed to meet projections under the plan.

## Helping The Sale's Force Make The Sale To Your Customer Emerging From Chapter 11 – More Credit Risk Than The Score Reveals?

These companies defaulted on their confirmed plan of reorganization, and post-confirmation debts, followed by the filing of a second bankruptcy petition to obtain the automatic stay (an injunction that arises automatically upon the filing of the petition that enjoins creditors from collecting on their pre-petition claims) and a second opportunity to pare down their debts, and a likely orderly liquidation of the debtor's assets.

A vendor that has provided goods or services to these companies during the first Chapter 11 case, or after these "reorganized" companies have emerged from Chapter 11, likely face a write-off of their open account with the second Chapter 11 filing. The problem is that a company which has spent a number of years in Chapter 11 and confirmed its operating plan of reorganization, and some time out of it, may pose complex legal questions in determining which assets are part of the new bankruptcy estate, which claims may be entitled to priorities, and which transactions may be recovered under the avoidance powers created under the Bankruptcy Code, all of which may waste the assets available to pay vendors. The recent trend of some companies willingness to file a second Chapter 11 raises new questions–and poses new risks–regarding a vendor's strategy of credit sales to a company that is presently in Chapter 11, as well as one that has emerged from Chapter 11. A vendor may question whether it should accept payment on a 503(b)(9) claim over time in exchange for credit sales. A vendor may also question whether as part of the first Chapter 11 plan, the debtor offers an increased distribution to unsecured creditors in exchange for credit sales post confirmation.

**The Confirmed Chapter 11 Plan Does Not Guarantee Payment On Future Credit Sales**

The primary purpose of a Chapter 11 case is the negotiation between a debtor and its creditors of a plan of reorganization which restructures the debtor's finances, provides the basis for repaying creditors and is the gateway through which a debtor emerges from Chapter 11. While a plan of reorganization takes many forms, a common form of the plan provides the company to continue to operate and pay vendors on their prepetition claims over time. The confirmation of the plan bars vendors from pursuing their preconfirmation claims and these claims are discharged and replaced by the new obligations specified in the plan. When the court confirms a plan of reorganization, it makes a determination that the plan is "feasible"; e.g. that the company is capable of meeting its obligations under the plan.

With large operating companies with many tiers of debt, in determining whether a plan is feasible, the bankruptcy court may take testimony from financial experts. However, as the recent press reports indicate, confirmation of a Chapter 11 plan does not mean that vendors will be repaid according to the terms of the plan or that vendors furnishing goods on credit post-confirmation will not face bankruptcy risk.

**Bankruptcy Courts Generally Do Not Bar Second Chapter 11 Filings**

The Bankruptcy Code does not expressly bar a company from filing a second Chapter 11, unlike an individual who files a Chapter 7 liquidation and obtains a discharge. Notwithstanding the Bankruptcy Code's absence of a bar on Chapter 22, bankruptcy courts that first considered whether a business that filed a second Chapter 11 are eligible, generally dismissed the case, forcing the reorganized debtor to liquidate its assets under the confirmed plan or convert to Chapter 7 liquidation.

These courts expressed concern that permitting debtors to file a second Chapter 11 was an attempt to circumvent the claims of the creditors who had participated in the first Chapter 11. These courts also expressed concern that

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"CONFIRMATION OF A CHAPTER 11 PLAN DOES NOT MEAN THAT VENDORS WILL BE REPAID ACCORDING TO THE TERMS OF THE PLAN "

## Helping The Sale's Force Make The Sale To Your Customer Emerging From Chapter 11 – More Credit Risk Than The Score Reveals?

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allowing a debtor to circumvent the provisions of a confirmed plan could dissuade vendors from working with a financially strapped debtor, especially those that had furnished goods on open account during the Chapter 11. These courts noted a second plan, if confirmed, could discharge the obligations created in the first plan, including priority claims, and the potential loss of priority status in the second case could dissuade vendors from providing postpetition trade credit.

The modern trend of bankruptcy courts, however, is to permit a company to file a second Chapter 11 petition, as opposed to forcing the company into an involuntary dismissal of the bankruptcy petition or conversion to Chapter 7 liquidation. These courts reason that the costs and creditors involved benefit more from a second Chapter 11 filing, than liquidation alternatives under Chapter 7 or state law. Often the two Chapter 11 filings are for different purposes, with the first Chapter 11 filing intended to reach a consensual plan of reorganization, while the second Chapter 11 filing is for a partial, or complete, liquidation of the company, with assets sold off to satisfy the secured creditor. While courts recognize the concern that vendors may sell on credit post-confirmation if there is perceived a risk of a second filing, courts refuse to dismiss a case on these grounds.

**Risks Posed to the Vendor**

As recent press reports indicate, even if a business confirms a plan of reorganization that proposes to pay vendors over time, there is no guarantee the business will still not return to financial straits and file a second Chapter 11. For debtors and creditors to cooperate in Chapter 11, Congress saw fit to maintain checks and balances between the parties. This is done, in part, by granting vendors that sell post-bankruptcy on credit a higher priority of payment than prepetition unsecured creditors, should a debtor fail to pay. A second Chapter 11 may strip the vendor of this priority.

Likewise, the filing of a second Chapter 11 poses special risks to prepetition unsecured vendors that are offered under the first plan of reorganization terms that allow vendors a more favorable payment on their unsecured claims should they supply the debtor on credit after the plan is confirmed. A second Chapter 11 filing treats these post-confirmation credit sales to the same priority status as other unsecured creditors. The willingness of companies to file a second Chapter 11 also raises the question of whether vendors should negotiate during the first Chapter 11 for payment terms under the plan of reorganization that excludes the payment of stock and instead press for payment in the form of a note. While vendors may seek stricter provisions in a Chapter 11 plan governing the liquidation of the debtor in the event of a post-confirmation failure, in reality a second filing would wipe any stricter provisions.

A company's willingness to file a second Chapter 11, and the bankruptcy courts generally allowing these, poses new risks to the credit professional. Perhaps the strongest reminder is that notwithstanding a reorganized company's assurances, supported by statements and projections prepared by its financial consultants that it has restructured its balance sheet, shed its unproductive assets and repositioned itself in the marketplace, there is the risk of a second Chapter 11 filing. Recognizing this, a credit professional may reevaluate whether credit should be extended to these companies emerging from Chapter 11, or insist on credit enhancements, such as a guaranty, security interest or deposit.

"A SECOND PLAN, IF CONFIRMED, COULD DISCHARGE THE OBLIGATIONS CREATED IN THE FIRST PLAN, INCLUDING PRIORITY CLAIMS"

## Having The Tough Conversation With A New Preference Action Client And Some Initial Steps To Take

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defenses to a preference demand. See 11 U.S.C. Sec. 547(c). The Bankruptcy Code sets the burden of proof for these defenses on the recipient of the funds. The two most common defenses are the "Ordinary Course of Business" defense and the "New Value" defense. In the case of both defenses, we would need you to provide us with significant documentation to prove these defenses. An attorney will need to review and analyze the following documents:

1. Any contracts or letters setting forth the terms of the relationship, specifically any payment terms;
2. Any purchase orders;
3. Any invoices;
4. Any delivery tickets;
5. Copies of any checks received (front and back);
6. Any communications discussing any payment issues between the parties, including changing of payment terms; and
7. Any information you may have on industry standards for receipt of payments.

The basic rationale behind the Ordinary Course of Business Defense is to show that the payments received during the Preference Period were made in the ordinary course of business amongst the parties. For example, if in the ordinary course, you required payment to be made Net 30 days, and all the payments were made within 30 days, including the preference payments, then the ordinary course of business defense will be a viable defense. Any deviation from your ordinary collection practices of the parties, whether forcing the customer to pay more quickly or allowing the customer more time to pay, could negate this defense. The best practice when presented with a creditor that may go bankrupt is to maintain the same payment terms and practices in order to preserve the Ordinary Course of Business Defense. If you feel you must make a change, then you could also start to require payment upon delivery, which qualifies for the Contemporaneous Exchange Defense. If there is no long term relationship between the parties, then the Court's have focused more on the industry standards to establish ordinary course. If the matter gets to the litigation stage, we would have to hire an independent expert to testify as to the industry standards.

The basic rationale behind the New Value Defense is to offset the preference payment received against any new value you extended to your bankrupt customer during the Preference Period for payment that was not received. For example, you received payment of $30,000 which the Trustee has now demanded you return as a preference. After receipt of this payment, you delivered to your customer new goods totaling $20,000. You did not receive payment for the goods. Under the New Value Defense, you would be able to reduce the preference claim by the $20,000 in new value you had extended to your customer. This would reduce the Trustee's preference demand to $10.000. The documents listed above are necessary to establish these two defenses, as well as the other defenses available in the Bankruptcy Code.

The purpose of this article was to provide a person being presented with a preference demand for the first time an understanding of the purpose behind the demand and some initial steps to take. Also, the article provides a basic discussion on two of the defenses available to a preference demand and the documentation necessary to help establish those defenses. If you are unable to resolve the preference demand at this stage, these same documents will be necessary to defend the lawsuit and provide during any discovery stage of the a litigation. There are several other defenses to a preference demand which may be available to you under the Bankruptcy Code given your specific facts and circumstances. We are available to discuss these issues and defenses with you if you do receive a preference demand letter or are served with a preference complaint.

"THE BEST PRACTICE WHEN PRESENTED WITH A CREDITOR THAT MAY GO BANKRUPT IS TO MAINTAIN THE SAME PAYMENT TERMS AND PRACTICES IN ORDER TO PRESERVE THE ORDINARY COURSE OF BUSINESS DEFENSE"

## Fear And *Lothian Oil*: Are Unsecured Creditors Under Greater Threat From Insider Loans?

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(1) the names given to the instruments, if any, evidencing the loan;

(2) the presence or absence of a fixed maturity date and schedule of payments;

(3) the presence or absence of a fixed interest rate and interest payments;

(4) the source of repayments;

(5) the adequacy or inadequacy of capitalization;

(6) the identity of interests between the creditor and stockholder;

(7) the security, if any, for the advances;

(8) the corporation's ability to obtain financing from outside lending institutions;

(9) the extent to which the advances were subordinated to the claims of outside creditors;

(10) the extent to which the advances were used to acquire capital assets; and

(11) the presence or absence of a sinking fund to provide repayments.

As with any such test, no one factor controls, and ultimately the judge is left to make a highly subjective "I know it when I see it" judgment. The approach suffers criticism for its inherent uncertainties, and potential for discouraging bona fide insider loans that might otherwise keep a struggling business afloat – anathema to the values of U.S. business law.

**The Threat of State Law and Choice-of-Law Clauses**

The reason *Lothian Oil*'s approach – i.e. leave it to the states – presents a credible alternative to the multi-factor *Autostyle* test is because of *Autostyle*'s awkward reliance on an unfashionable provision of the Bankruptcy Code. Courts taking the multi-factor approach have always cited section 105(a) of the Bankruptcy Code as supporting the doctrine of recharacterization. This is the provision of the Bankruptcy Code that enables the court to issue "any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." In other words, it is the "when all else fails, and justice requires it, we'll do whatever we want"-provision, and the default argument of bankruptcy lawyers everywhere that are badly stuck for an argument. It has come to be used sparingly.

*Lothian Oil*, on the other hand, finds authority in section 502(b)(1) of the Bankruptcy Code, which requires the Bankruptcy Court to hold a hearing to determine the amount of a creditor's claim if there is an objection to it, and disallow it if "such claim is unenforceable … under any agreement or applicable law." The key language is "applicable law," which is another way of saying "state law." By finding authority in this provision, *Lothian Oil* sidesteps the problem of using section 105(a), which most courts disfavor, and arguably creates a sounder theoretical basis for recharacterization.

"RECHARACTERIZATION WOULD ONLY BE ALLOWED IF THERE IS A BASIS FOR IT IN STATE LAW"

The knock-on effect though is that recharacterization would only be allowed if there is a basis for it in state law. In the *Lothian Oil* case, the court looked to Texas law, which, as it happened, applied a similar multi-factor test to *Autostyle*, imported from federal tax law. In other states, such as Massachusetts and Wisconsin, recharacterization would be allowed only where there has been some inequitable conduct by the lender. What of New York, Delaware and California law, one of which will usually govern interpretation of a loan contract? The answer, unfortunately, is unclear. The law of these jurisdictions on this issue ap-

## Fear And *Lothian Oil*: Are Unsecured Creditors Under Greater Threat From Insider Loans?

pears to be surprisingly underdeveloped.

Though it is praised for potentially bringing certainty to a very convoluted area of the law, would *Lothian Oil* be a net positive or net negative for the trade if widely adopted? The answer is probably a net negative. If the lender is sophisticated, the loan will contain a well thought-out choice-of-law clause. It is easy to see a lender-friendly jurisdiction such as Delaware adopting, by legislation if necessary, a framework for recharacterization that requires lender misconduct, and raises the bar for unsecured creditors seeking to recharacterize loan transactions. By simply choosing this as the governing law of the contract, lenders could stack the odds against later recharacterization.

**Takeaways**

Although this debate takes place in a realm of theory well divorced from the day-to-day decisions of most credit managers, it is nonetheless worth considering whether you are doing everything you can to guard against being burned by insider loans. Here are some good practices:

Request detailed financial statements when extending credit to better understand the customer's capital structure.

Consider inserting a provision in your credit application to the effect that:

"As of the date of execution of this application, Customer has no outstanding debt obligations whatsoever to any of its directors, officers, shareholders, or any individual or entity meeting the definition of "insider" under 11 U.S.C. § 101(31). Customer further warrants and represents that it will promptly notify Supplier if Customer incurs any indebtedness to its shareholders, directors, officers or "insiders" in an aggregate amount greater than $20,000."

Review UCC filings against the company when first approving a credit line and set up reminders for quarterly reviews thereafter to catch subsequent filings against the customer. Remember, a shareholder can lend money on an unsecured or secured basis. It is harder to cry foul and claim a loan should be recharacterized, when the creditor has been on notice, or should have been on notice, of the loan because of a publicly-filed UCC-1 statement.

Whether *Lothian Oil* takes off outside its circuit, or ultimately becomes a footnote, we have not heard the last word on recharacterization. So watch this space.

1. The first approach was endorsed in 1986 by the 9th Circuit Bankruptcy Appellate Panel - *In re Pacific Express*, 69 B.R. 112 (9th Cir. B.A.P. 1986) - a decision which has been roundly criticized for conflating and confusing the concepts of recharacterization and "equitable subordination," a related doctrine, that can be invoked as a remedy in similar settings, but one that focuses on the fairness of the lender's conduct rather than on the formal and circumstantial attributes of the loan. The second approach, adopted by the 11th Circuit in *Estes v. N & D Props., Inc. (In re N&D Props., Inc.)*, 799 F.2d 726, 733 (11th Cir. 1986) has also been acidly criticized as "invented without citation to relevant precedent." James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, The Business Lawyer; Vol. 62, p. 1257 (2007)

2. *See Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 747–53 (6th Cir. 2001)

"IF THE LENDER IS SOPHISTICATED, THE LOAN WILL CONTAIN A WELL THOUGHT-OUT CHOICE-OF-LAW CLAUSE"

## Must Trade Creditors Continue Doing Business With Delinquent Customers Who File Bankruptcy, And What Protections Are Available?

*(Continued from page 4)*

that obligation persist post-petition?

No reported decision from any circuit court of appeal has held that a vendor's refusal to extend credit to a bankrupt customer, without more, constitutes a violation of the automatic stay. However, trade creditors need to distinguish between the post-petition *cancellation* of an executory contract (which is unlawful)[8] versus a demand for assurances of payment.

The three decisions discussed below found trade creditors to be entitled to varying degrees of post-petition protection, ranging from nothing, to nothing short of the debtor's complete cure of all pre-petition defaults.

Erring as they should on the side of caution, trade creditors need to be mindful of the decision of the district court for the northern district of California in *In re Pacific Gas And Elec. Co.,* 2004 U.S. Dist. LEXIS 22023 (N.D. Cal. 2004). There the debtor was a public utility company and the non-debtor vendors supplied it with electricity. *Id.* at 2-3. Although conceding that "the question is not free from doubt" (*id.* at 10), the *Pacific* court ultimately compelled the suppliers to resume performance under an executory contract despite the fact that the suppliers' right to suspend performance *pre-petition* was undisputed (*id.* at 10) and the debtor owed the suppliers approximately $120 million in pre-petition debt (*id.* at 11).

While acknowledging that the suppliers were entitled to request adequate assurances of performance under U.C.C. § 2609(1) *pre-petition*, the court found that "upon [the debtor's] filing of [a] petition under Chapter 11 of the Bankruptcy Code, the state commercial code is no longer controlling and the [suppliers] were required to resume performance under the executory contract with [the debtor]." *Id.* at 13.

Observing that the bankruptcy code "seeks to 'suspend the normal operation of rights and obligations between the debtor and his creditors' [and] 'prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources[;]'"[9] the *Pacific* court considered that "a holding that the [suppliers] were entitled to withhold their performance until [the debtor] had provided sufficient assurances of financial recovery would vitiate the clear legislative purpose to provides (sic.) the debtor with 'breathing space' while the contract is pending assumption or rejection." *Id.* at 16. The court further held that the non-debtor suppliers' only remedy was to file a motion to expedite the debtor's decision to assume or reject the contract under 11 U.S.C. § 365(d)(2). Until that time, "the Bankruptcy Code requires the non-debtor party to perform its obligations under the terms of the contract, or suffer the remedies for breach if it fails to do so." *Id.* at 20-21.

A second case worth discussing is *In re Continental Energy Assocs. Ltd. Pshp.,* 178 B.R. 405 (Bankr. M.D. Pa. 1995). There the debtor sought a court order compelling a vendor to continue performance under a supply contract until such time as the debtor decided to assume or reject it. *Id.* at 407. The debtor was already in arrears in the amount of $15 million from *before* the bankruptcy filing. As a form of security, the debtor offered to pay the supplier cash in advance to ensure the supplier's post-petition performance would be fully compensated.

The bankruptcy court held, first, that it was empowered to compel a vendor to supply goods or services, at a price mandated by the court, post-bankruptcy and pending assumption or rejection of the contract.[10] While expressing concern about "the Fifth Amendment rights of an entity to be compensated for property," the court observed that "the Debtor is now paying to [the supplier] the contract amount in advance…" Thus, the court considered that the supplier's "Fifth Amendment rights are vigilantly being guarded[.]" *Id.*

5. *See e.g. In re Dana Corp.*, 2007 Bankr. LEXIS 3927, *7-8 (Bankr. S.D.N.Y. 2007) ("A 'blanket' purchase order of the type at issue here is not a contract for a specific volume of parts, nor is it a 'requirements' contract obligating the purchaser to continue to buy parts from the supplier. Each time a specific release under a blanket purchase order is fulfilled by the supplier and paid by the purchaser, the contractual relationship in essence ends unless the purchaser issues another release.")

6. *Id* at *8 (applying Michigan law); *see also Ketcham v. Hall Syndicate, Inc.*, 37 Misc. 2d 693, 699 (Sup. Co. N.Y. Cty 1962) ("Absent a fixed or determinable duration or an express provision that the duration is perpetual, the contract is one terminable at will") (applying New York law); *Zimco Rests., Inc. v. Bartenders and Culinary Workers Union, Local 340, AFL-CIO*, 165 Cal. App. 2d 235, 331 P.2d 789, 793 (Cal. Dist. Ct. App. 1958) ("The rule is well established in California" that "[a]s to contracts contemplating continuing performance for an indefinite time, the general rule is that such contracts are terminable at will by either party.").

7. *See e.g. In re Dana Corp., supra* at *13.

8. *See e.g. In re Coast Trading Co.*, 26 B.R. 737 (Bankr. D. Or. 1982) ("[P]ost petition attempts at cancellation would be in violation of the automatic stay provisions of 11 USC § 362 and the executory contract provisions of 11 USC § 365.")

## Must Trade Creditors Continue Doing Business With Delinquent Customers Who File Bankruptcy, And What Protections Are Available?

The *Continental* decision is noteworthy for its implicit recognition that, separate and apart from bankruptcy law, creditors have certain inalienable constitutional rights that should not be disregarded. It also supports the position that a creditor may demand cash in advance, post-petition, from a debtor who is already in default. However, the decision is not binding on other courts.

Finally, the decision of the bankruptcy court for the Western District of Michigan in *In re Lucre, Inc.,* 339 B.R. 648, 650 (Bankr. W.D. Mich. 2006) is particularly friendly to trade creditors. Importantly, the creditor in *Lucre* did not seek to terminate its agreement with the debtor or exercise its contractual setoff rights, but merely sought relief from the "ongoing burden" of having to provide post-petition service to the debtor. *Id.* at 651. The executory nature of the contract having been conceded (*id.* at 650), the *Lucre* court framed the issue as follows: "[W]hat, if any, section of the Bankruptcy Code empowers *Lucre*, as debtor-in-possession, to compel [the non-debtor] to continue performance under the…agreement notwithstanding *Lucre's* alleged pre-petition breach…?" *Id.* at 655.

The *Lucre* court considered that "a trustee or debtor-in-possession cannot otherwise demand performance from the other party to the contract when the debtor's pre-petition breach under the contract remains uncured." *Id.* at 658. Summarizing the rule and its rationale, the court held that "[t]he mere commencement of the bankruptcy case and the attendant imposition of the automatic stay do not by themselves empower a debtor…to compel from the other party to an executory contract performance the day after the commencement of the bankruptcy case when the debtor had no right to compel that performance the day before. Consequently, it is illogical to contend that the non-debtor party's justifiable refusal to perform under an executory contract post-petition is somehow a violation of the automatic stay." *Id.* at 660.

It is also notable that, in considering the issue of what constitutes adequate post-petition protection, the *Lucre* court went a step further than *Continental* by holding that "the pre-petition breach in and of itself justifies continued non-performance by the other party *regardless of what the debtor may offer as post-petition 'adequate protection.'* The trustee or the debtor-in-possession must also cure the *pre-petition* default as part of a Section 365 assumption of the executory contract if it is to regain its right to demand performance from the other party." *Id.* at 659 (emphasis added).

That additional holding is significant because, even where a debtor agrees to pay cash in advance post-petition, a trade creditor is not completely protected because the bankruptcy court may subsequently review the terms of the parties' post-petition supply arrangement for reasonableness.[11]

It should be noted that *Lucre* is something of an aberration and should not be considered a guiding standard.

**C. Conclusion.**

A creditor can incur severe penalties if it is deemed to have violated the automatic stay under § 362 of the Bankruptcy Code. Thus, where a debtor has even a colorable argument that a contract is executory, rather than risk an adjudication it can't live with, the prudent creditor will reach a consensual agreement with which they can. Nonetheless, when faced with a debtor demanding post-petition performance under a contract where they are already in default, a vendor certainly has no reason to feel legally helpless.

9. *Id.* at 14, citations omitted.

10. *Id.* (citing *In re Whitcomb & Keller Mortg. Co.,* 715 F.2d 375 (7th Cir. 1983).)

11. *See e.g. Continental Energy Assocs. Ltd. Pshp, supra* at 409 (acknowledging that an election by a debtor to assume an executory contract results in an assumption of the contract "with all of its burdens," but observing that, nevertheless, "[i]f the Debtor, prior to assumption, elects to enforce the contract, and this court were to condition such enforcement on payment of the consideration in the contract not subject to further review for reasonableness, then we would be placed in a position of authorizing an administrative expense that may be violative of 11 U.S.C. § 503(b)(1).").

## Recent Developments Regarding Section 503(b)(9) Of The Bankruptcy Code

*(Continued from page 2)*

"ONLY TIME WILL TELL AS TO WHETHER THE *MOMENTA* COURT'S DISCUSSION ON CONSTRUCTIVE POSSESSION WILL SPRING INTO A NEW AREA OF 503(B)(9)"

The bankruptcy court in the *Momenta* case did not stop there, however. The *Momenta* court also held that mere constructive possession of goods by a debtor qualifies as "receipt" for 503(b)(9) purposes. This is a departure from the popular rule requiring physical possession to have "receipt" under 503(b)(9). The *Momenta* court cited a non-bankruptcy case wherein a gasoline vendor was not allowed to stop delivery of gasoline that had already been delivered to a tank at a yard that the customer rented. The *Momenta* court enters dangerous waters here. As a starting point, if the gasoline vendor's customer rents the storage tank, or storage rights in the storage tank, then it is in possession of the tank, and so it is in possession of the gasoline pumped into the tank. But more importantly, the *Momenta* court's expansion of the definition of "receipt" greatly expands the pool of creditors that would now qualify for 503(b)(9) claims. Only time will tell as to whether the *Momenta* court's discussion on constructive possession will spring into a new area of 503(b)(9), but this could have a significant effect on 503(b)(9) were it adopted by other courts. We will all need to stay tuned on this issue.

The *Momenta* court also tackles the topic of disallowance of a 503(b)(9) claim in the face of a preference action. The typical scenario is that a vendor obtains allowance of a 503(b)(9) claim early in the case. Pursuant to the bankruptcy code, 503(b)(9) claims must be paid in cash on the effective date of the plan. Ergo, a debtor may not exit chapter eleven without paying 503(b)(9) claims in full upon the effective date of the plan unless a 503(b)(9) claimant agrees to different treatment. What debtors have attempted to do is disallow a 503(b)(9) claim when a preference payment has been made under 502(d) of the bankruptcy code. Section 502(d), in part, disallows claims against a debtor's estate when there are preferential payments that must be returned to the estate.

The majority view of bankruptcy courts around the country is that a 503(b)(9) claim cannot be disallowed simply because a vendor also received preferential payments. In a nutshell, these courts have held that 502(d) deals with claims, and 503(b)(9) is an administrative expense. These courts hold that 503(b)(9) claims must still be paid upon the effective date of the plan, even where a preference action may later be instituted against that vendor. There are a minority of bankruptcy courts that have allowed the temporary disallowance of 503(b)(9) claims when preferential transfers have been made. These courts have temporarily disallowed the 503(b)(9) claim of a vendor until the preferential transfer issues have been worked out, and payment made back to the estate.

The *Momenta* court takes the majority approach. A 503(b)(9) claim in the district of New Hampshire cannot be disallowed simply because the vendor also received a preferential payment.

The *Momenta* case touches on these two very important topics for vendors dealing with their customers. The *Momenta* decision is not yet set in stone. The appeal of the case could change the way vendors view receipt. The case could also further solidify the majority rule regarding the interplay between 503(b)(9) and 502(d).

The *Momenta* case serves to highlight the fact that vendors want to ensure they stay informed when it comes to recent developments in bankruptcy law. Areas of bankruptcy law such as 503(b)(9) are ever-evolving. Vendors also need to understand the differences in the treatment of these topics by courts depending on region, and understand how courts will treat their claims depending on where their customer is located. An understanding of issues like those raised in *Momenta* will serve vendors well.

## The Sole-Source Supplier: Working Through Your Key Customer's Financial Difficulties While Bettering Your Position For Payment On The Delinquent Account

*(Continued from page 1)*

The strategies considered below are consistent with conventional credit enhancements, such as letters of credit and deposits, which purpose is to reduce credit risk yet make the sale whether the customer is current or delinquent. But the strategies considered below take into account the unique co-dependency trade relationship where a vendor is a sole source supplier to the customer, and the customer is a source of significant revenues for the vendor. These strategies presuppose a team approach from the vendor: the credit function collaborating with the sale's force along with senior management to target a revenue number while managing credit risk.

**The Sole-Source Supplier: What Makes You Unique**

If the vendor has a unique product or service, such as a patent for example, or a unique competitive position, such as a plant in close proximity to the customer, the vendor may be in a position to command a long term supply or outputs contract. The downside for the vendor is that the customer's significant source of revenue can create a co-dependant relationship that may unwittingly ratchet up the credit risk.

**Changing Up the Trade Relationship**

**From Vendor to Lender:** to retain the significant source of business, the vendor may consider a short term loan to assist the customer's cash flow. Creditor status gives the vendor priority in the event the customer fails to repay, as opposed to investing in the customer. The tension with this strategy is the customer's capital structure. The customer likely has a preexisting lender which holds a security interest in all of the customer's assets. This lender likely has a say with any financing, even though the vendor would be junior to its secured liens. The vendor may negotiate a secured position, but that security is second to the existing lender.

**From Vendor to Investor:** the customer solicits your company to invest in it to continue to operate during the short-term downturn. The tension with this strategy is the risk that the equity investment is lost because of the customer's deteriorating financial position. The equity investment is last in line as to right for payment.

**From Vendor to Guarantor:** the vendor may consider serving as a guarantor for certain of the customer's debts. The upside for the vendor is that it may not require them to make an immediate infusion of cash. However, the risk is that the vendor may be called on to pay on the guarantee if the customer fails to pay the guaranteed debts. The vendor guaranty is to encourage the customer's suppliers to continue to provide trade credit, thereby stabilizing cash flow. The guarantee may calm suppliers and allow the customer to continue to operate.

**From Vendor to Working with the Customer's Lender:** the customer's lender has a security interest in all of the customer's assets including accounts receivable, inventory and cash. The vendor may be able to calm the lender's anxiety with the customer's financial performance by committing to guarantee certain of the customer's accounts receivable, or guarantee a floor for the lender's collateral should it be forced to foreclose on the customer. The tension with this strategy is the amount the vendor must guarantee compared with the value of the trade relationship.

**From Vendor to Third Party Guarantees:** the vendor may insist that the owner of the customer (if a closely held company) provide a personal guarantee to the vendor to protect it for its trade credit or financing. The guaranty creates a contract of secondary liability. The customer's owner may provide the guarantee to the vendor given the alternative that the customer's lender may foreclose on the business. Likewise, the customer may have an affiliate business with value that may furnish a guarantee to the vendor. The tension with this

*(Continued on page 16)*

"THE CUSTOMER'S SIGNIFICANT SOURCE OF REVENUE CAN CREATE A CO-DEPENDANT RELATIONSHIP THAT MAY UNWITTINGLY RATCHET UP THE CREDIT RISK"

## The Sole-Source Supplier: Working Through Your Key Customer's Financial Difficulties While Bettering Your Position For Payment On The Delinquent Account

*(Continued from page 15)*

strategy is that owners are resistant to furnish personal guarantees if they have personal net worth.

**From Vendor to Owner:** in certain situations, the vendor may determine that the economics are such that buying the customer may be the most effective way to maximize the value of the relationship. This is the ultimate equity investment.

The vendor must be vigilant with its approach to financially assist the customer in a sole-source trade relationship. The opportunities that the strategies discussed may present to the vendor are preserving the trade relationship and the sizeable revenues. The downside with the strategy may be the vendor increasing its credit or investment exposure. Further, a vendor may find that too close a trade relationship with the vendor may open the door to be labeled an insider under the Bankruptcy Code which may extend the preference exposure from 90 days to one year, should the customer file bankruptcy.

## Does A Critical Vendor Lose Its New Value Defense To A Preference Action?

*(Continued from page 1)*

preferring a vendor by the requirement that any vendor that receives a greater payment than similarly situated vendors disgorge the preference so that like vendors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period may be recaptured. One of the most effective and commonly used preference defenses used by a vendor is the subsequent new value or subsequent advance rule, which excludes from recapture those payments to a vendor who subsequently extends goods or services (or credit for those goods or services) to the debtor.

"NOT ALL TRANSFERS MADE WITHIN THE PREFERENCE PERIOD MAY BE RECAPTURED"

**Beating the Preference Lawsuit: The Subsequent New Value Defense**

The subsequent advance rule has its most frequent application where a vendor provides goods or services on open account and the debtor pays the vendor at various points during the preference period. Congress intended to protect the open account vendor with the subsequent new value rule. Under this analysis, a single transfer during the preference period is not analyzed in isolation from the overall course of business between the vendor and debtor, as the basis for maintaining the open account is the debtor's entire financial picture and not the debtor's most recent payment.

The objectives of the subsequent new value rule are: (1) to encourage a vendor to continue to extend credit to financially troubled debtor, possibly helping the debtor avoid bankruptcy; (2) to promote equality among vendors; and (3) to reward vendors who actually enhance the estate during the preference period. Without the exception, a vendor who continues to extend credit to the debtor would merely be increasing its bankruptcy loss and in effect be punished for continuing to work with the debtor.

**Application of the Subsequent New Value Defense**

As a hypothetical, on January 1 the debtor gives an unsecured vendor a check for $10,000 for

## Does A Critical Vendor Lose Its New Value Defense To A Preference Action?

*(Continued from page 16)*

goods supplied. On January 5, the vendor provides the debtor an additional $10,000 in goods on open account (no purchase money security interest is taken in the goods). On February 1 the debtor files bankruptcy. The January 1 payment, made within 90 days before the bankruptcy filing, may be recaptured as a preference assuming that the criteria for the preference law were met. However, because the subsequent advance of goods by the vendor replenished the bankruptcy estate, the subsequent new value rule permits the vendor to reduce its January 5 advance against the preference, and does not have to disgorge the payment. But what if the court approves the debtor's critical vendor motion and the debtor pays the vendor for the January 5 shipment pursuant to the order? Does the vendor lose its new value defense?

**Friedman's v. Roth Staffing**

During the preference period, Friedman's paid $81,997.57 to Roth. Subsequently, but before the bankruptcy, Roth provided $100,660.88 of services to Friedman's for which Roth was not paid. Through the approval of a wage motion, the Court authorized Friedman's to pay Roth for pre-petition staffing services and Roth was paid $72,412.71.

In February of 2009, Friedman's filed a complaint against Roth to recover $81,997.57 as a preference. Friedman's filed a motion for summary judgment, arguing that post-petition payment under the motion relates back to the preference period and reduces the amount of Roth's subsequent new value defense from $100,660.88 to $28,248.17, leaving a preference claim of $53,749.40.

The issue before the court is whether or not the post-petition payment of pre-petition new value affects the preference defense. The parties disagree as to whether calculation is "fixed" as of the petition date (our position), or remains subject to post-petition events such as payments made to Roth under the motion (Friedman's position).

In resolving this issue, the Court cites the Third Circuit's holding in New York City Shoes, Inc. v. Bentley International Inc. Although the Circuit did not address this particular issue in this case, their definition of the subsequent new value defense is relevant and compels the conclusion that the "fixed" approach is correct. The Circuit held that one of the three elements of the subsequent new value defense is that the debtor must not have fully compensated the creditor for the "new value" as of the date that it filed its bankruptcy petition. The inclusion of the last clause implicates that subsequent provision or payment of new value doesn't affect preference analysis even if the debtor completely compensates the creditor for its pre-petition claim. It clearly supports fixing the entirety of the preference analysis as of the petition date.

The Delaware court held that the filing of bankruptcy "fixes" the preference analysis as of petition date, and the Court denied Friedman's motion for summary judgment.

The decision clearly provides comfort and extra motivation for creditors to agree to continue to provide post-petition goods or services under a critical vendor motion. How does this ruling effect a vendor's new value defense in relation to 503(b)(9)? I will examine the issue thoroughly in my next article, but it certainly could have an impact.


We're on the web!

www.blakeleyllp.com

BLAKELEY & BLAKELEY LLP



2 Park Plaza, Suite 400
Irvine, California
92614

Phone: 949-260-0611
Fax: 949-260-0611
E-mail: info@blakeleyllp.com



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100 Park Avenue, Suite 1600
New York, New York
10017

Phone: 212-984-1033
Fax: 212-880-6499

444 South Flower, Suite 1750
Los Angeles, California 90071
Phone: 213-599-8017
Fax: 213-599-8018

1000 N. West Street, Suite 1200
Wilmington, Delaware 19801
Phone: 302-300-4624

71 Stevenson Street, Suite 400
San Francisco, California 94195
Phone: 415-728-0057
Fax: 415-728-0058