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Logged Off: Your Technology Company Customer May Soon Be Insolvent

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The press is abounding with stories of how web based and technology companies are transforming business. Technology companies, known for little cash flow, few tangible assets and speculative profits, are transforming the marketplace and providing an opportunity for vendors who are always looking for added sales channels. However, a number of initially wellfunded technology companies have closed their doors, and auditors for several well-known technology companies have issued warnings that the technology companies survival may be in substantial doubt. Is this the beginning of a technology company shakeout? What is the risk and opportunities of selling to a technology company? What are the red flags that indicate a technology company may not meet its open account sale? Even if a credit professional does not sell to technology companies, do the vendors' customers rely on technology companies for a meaningful source of revenue, and thus the vendor's credit portfolio may be indirectly at risk with a technology company shakeout.

Technology Companies: Explosive Growth, And Now the Shakeout?

The IPO stock frenzy is allowing many technology companies to build their businesses by selling stock or attracting venture capitalists. Profits were never expected immediately from most technology companies, but investors may be growing restless. Some technology companies have burned through operat-

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A New Installment On The "*Kiwi* Defense" To A Preference Action

Bradley D. Blakeley, Esq.

When a creditor provides services to a debtor, one of the considerations given is whether such services should be done on a long-term contract basis. Although not always at the top of a credit manager's considerations, the benefits are that if such executory contract is assumed by a debtor postpetition, the debtor must cure the creditor's prepetition claim and the assumption should insulate the creditor from preference exposure. The Delaware bankruptcy court recently considered the broad issue in the recent case of *Guiliano v. Almond Investment Company* (In re *Carolina Fluid Handling Intermediate Holding Corp.*). It further considered the underlying components of what is contract assumption and assignment.

But first, what is a "*Kiwi* defense" and how did it originate? The most applicable case law regarding pursuit of preference actions against counterparties to assumed executory contracts comes from the Third Circuit's holding in

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Special points of interest:

- Technology Companies
- "Kiwi defense"
- 503(b)(9) Developments
- Guaranties
- Credit-Bid Rights
- Preference Actions
- Delaware's Default Standard

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Ronald A. Clifford, Esq.

Recent Developments Regarding 503(b)(9)

Section 503(b)(9) of the Bankruptcy Code, which took effect in late 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act, affords administrative priority to goods received by the debtor within 20 days of the Chapter 11 filing, given that the goods were sold in the ordinary course of business. Debtors with a significant amount of 503(b)(9) liabilities can deal with these claims through several venues. Sometimes, debtors file a motion to allow payment of these administrative claims; however, similarly to a critical vendor motion, a debtor will condition the payment on the vendor agreeing to supply goods and services to the debtor through a post-petition supply contract. Other times, a debtor will file a motion to establish procedures for asserting 503(b)(9) claims, as was done in the bankruptcy of a recently filed Chapter 11, AFA Investments, Inc.

AFA Foods purchases large amounts of meat and meat products to be processed through its production operations, some that were received in the ordinary course of business and within 20 days of its bankruptcy filing. In order to deal with claims stemming from these purchases, AFA filed a motion requesting the court to approve specific procedures for asserting and solidifying these 503(b)(9) claims. In the motion, AFA argued that there was no reason to differentiate between the procedures by which Twenty Day Claims and other prepetition claims were filed. Furthermore, AFA requested that 503(b)(9) claims should be pursued through the regular claims process. This would require claimants to utilize the proof of claim form and file their claims by the general bar date (to be set by a subsequent order). Additionally, AFA requested that claimants not be allowed to file motions to compel allowance or payment of these administrative expenses nor that any portion of these procedures be able to provide a claimant with a defense to a preference action.

One of AFA's packaging suppliers objected to the debtors' motion to establish 503(b)(9) procedures on the basis that it failed to establish a probability in payment in full of these claims and that it failed to propose certain procedures for filing, objecting to, and adjudicating these claims. The creditor claimed that AFA was attempting to use the court to liquidate secured lenders' collateral without paying all administrative claims in full. It argued that the bankruptcy court should not approve any financing for AFA unless all reasonable assurances are provided that the case will not be rendered administratively insolvent. The vendor viewed AFA's motion to establish a process for asserting 503(b)(9) claims as barring claimants from demanding payment until post-sale of all of AFA's assets. AFA's motion contained no mention of the process and timing under which these claims would be allowed, and when payments would be made.

Concurrently with its objection, the vendor filed a cross-motion for allowance and payment of 503(b)(9). It requested the court's authorization for the debtors to pay all allowed 503(b)(9) claims in the ordinary course. The motion argued that is unfair to prevent payment of the 503(b)(9) claims, but contrastingly provide for payment of other equally ranked administrative classes. If AFA and secured lenders failed to provide for means to assure equal treatment of claims, the vendor requested that the court prevent payment of other administrative claims and either dismiss or convert the case to a Chapter 7.

The court has entered an order establishing procedures to assert 503(b)(9) claims (5/8/12), however at the Status Conference on June 26, 2012, the debtors are to either (i) present to the court an update of the status of these claims and (ii) either propose claims procedures for the resolution of these claims or request additional time to propose such procedures. Accordingly, there still is no solution to the objections brought up by International Paper Company.

Are You Jeopardizing The Collectability Of Your Accounts With A Stale Guaranty?

In the era of multi-national conglomerates, the tangle of subsidiaries, divisions, affiliates, etc. under any given corporate umbrella is increasingly complex. There are usually sound motivations for this, including tax strategy and ring-fencing the potential liabilities of a problematic subsidiary. Most credit departments probably have a limited knowledge of the web of companies sitting underneath the corporate parent, and indeed the details are not something a credit department generally need concern itself with. Apart from being complex and not that interesting, the issue is one for your in-house legal department. Nonetheless every so often a diligent credit manager should ensure that the complexities of the corporate group will not impinge the department's ability to collect a delinquent account, and an area where this is capable of happening is customer guaranties.

Not much needs to be said about the benefits of a personal guaranty to a credit manager. For all the U.S. bankruptcy system has to recommend it, it is brutally unfair to unsecured creditors most of the time, and bankruptcy often carries with it no adverse consequences for the businessman who recklessly, or even fraudulently, trades his company into insolvency. Thus, a valid personal guaranty is a crucial piece of leverage when an account is past due. However, when you dust off your former best customer's file, after he has become heavily delinquent and started dodging your calls, you want and need that guaranty to be enforceable.

Guaranteed Success(ion)

A guaranty can take multiple forms, and ensuring its effectiveness can be delicate. There is no uniform U.S. law of guaranties, leading to some wide divergences between the various states. Depending on a guaranty's language, it could be a "guaranty of payment" (meaning you can sue the guarantor immediately if the primary debtor fails to make payment when due), or a "guaranty of collection" (meaning you must sue the primary debtor first, win, and fail to collect the judgment before suing the guarantor). It could be limited or unlimited in amount. It could be effective for a finite duration or continue indefinitely. Even a continuing guaranty can be discharged if you alter the primary debtor's obligations so as to leave the guarantor more exposed, or it could just be revoked at any time. But in a complex corporate group, you are potentially faced with additional problems even if the guaranty was well drafted to begin with.

From time to time, a large conglomerate will incorporate new entities, and dissolve others, and the functions and responsibilities of the various divisions are liable to change at management's direction. Management's considerations will not be the details of enforcing individual guaranties, but their actions could have knock-on effects. Even if a team of corporate lawyers examines the legal effects of organizational changes, it doesn't mean that every scenario or changed circumstance is accounted for. So, by way of example, invoices to Customer X, may have been issued by Subsidiary Y, but Customer X's ten year old guaranty was executed in favor of Subsidiary Z, which used to service Customer X until Customer X entered a different geographic market 5 years ago, where supplies were handled by Subsidiary Y. If this guaranty does not hold up, and your profit center takes the hit, the corporate lawyer who failed to foresee this will not be there to take re-

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Johnny White, Esq.

"A DILIGENT CREDIT MANAGER SHOULD ENSURE THAT THE COMPLEXITIES OF THE CORPORATE GROUP WILL NOT IMPINGE THE DEPARTMENT'S ABILITY TO COLLECT A DELINQUENT ACCOUNT

Supreme Court To Resolve Circuit Split On Secured Lenders' Credit-Bid Rights In Chapter 11 Plan Sales: Consequences For Secured And Unsecured Creditors

David Mannion, Esq.

THE HIGH COURT'S DECISION WILL HAVE AN OBVIOUS AND IMMEDIATE IMPACT FOR SECURED CREDITORS

Credit-bidding is a fairly straightforward process. Assume that a bankrupt debtor owns a hotel with an appraised value of $5 million. The debtor's lender is owed $10 million secured by a mortgage on the hotel. A public auction of the hotel takes place and a potential buyer bids $7 million. However, before the auction closes the lender submits a $7.1 million "credit bid." If no further bids take place, the lender gets the hotel. No cash changes hands, but the lender's secured claim is reduced by $7.1 million and they get an unsecured "deficiency" claim of $2.9 million (i.e. $10 million minus $7.1 million). Ordinarily, a secured lender can bid up to the full amount of its secured debt without regard to what the collateral (in this case the hotel) is actually worth or, perhaps more accurately stated, what other potential buyers *consider* it to be worth.

In 2010 a divided panel of the Third Circuit Court of Appeals, whose decisions are binding on the Delaware bankruptcy courts, held that the language of § 1129(b)(2)(A) of the Bankruptcy Code allows a debtor to sell a secured creditor's collateral free and clear of liens under a plan, without providing a right to credit-bid. *In re Phila. Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). Last summer, a unanimous panel of the Seventh Circuit decided just the opposite; that a debtor cannot sell a secured creditor's collateral free and clear of liens under a plan without affording them the right to credit-bid. *River Rd. Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2011). The United States Supreme Court heard oral argument in *River Road* on April 23, 2012, and is expected resolve the circuit split as soon as next month. The case title is *Radlax Gateway Hotel v. Amalgamated Bank* (Sup. Ct. Docket No. 11-166.)

The High Court's decision will have an obvious and immediate impact for secured creditors, particularly in the loan-to-own context where private equity firms interested in owning their borrowers' businesses may be less willing to invest their capital. However, a topic that has been less widely discussed is how, if at all, the decision may affect unsecured creditors.

In *Philadelphia Newspapers* the plight of the unsecured creditors was relegated to a footnote in the majority opinion which considered that "[o]nly the plan treatment of secured lenders is the subject of this appeal, though unsecured lenders assert that they have an interest in the treatment of secured lenders under the Plan because the Lenders have agreed to waive deficiency claims if they are permitted to credit bid." *In re Phila. Newspapers, LLC*, 599 F.3d 302. In the *River Road* decision, unsecured creditors did not even get a mention. So was this an oversight, or do the holdings really affect unsecured creditors in any meaningful way?

One of the more interesting discussions in each of the cases addresses whether a secured lender can ever realize the "indubitable equivalent" of its collateral (which is what it is entitled to receive under the Bankruptcy Code) if it is not permitted to credit-bid. The logic is that things are worth whatever people are willing to pay, and a successful credit-bid, in effect, defines the value of the collateral. *See In re Phila. Newspapers, LLC*, 599 F.3d 320-321 (Ambro J., *dissenting*) (*citing In re SubMicron Sys. Corp.*, 432 F.3d 448, 460 (3d Cir. 2006)). According to Judge Ambro, a secured lender will not credit-bid more than its collateral is worth and, conversely, will *only* credit-bid if it believes its collateral is being sold for less than market value. *Id* at 321. Thus, Judge Ambro was of the opinion that credit-bidding "helps to minimize the deficiency claims that can be asserted against the rest of the bankruptcy estate and other unencumbered assets, maximizing recovery for all creditors." *Id.* at 333.

Relatedly, in *River Road* the Seventh Circuit considered that "[b]y granting secured parties [the] ability [to credit-bid], the Code provides

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Delaware's Default Standard For Discovery – When To Start Your Preparation

On December 8, 2011, the U.S. District Court for the District of Delaware adopted a *Default Standard for Discovery, Including Discovery of Electronically Stored Information ("ESI")* (the "Default Standard"). This Default Standard sets forth the floor for how parties to litigation are to conduct discovery of ESI in Delaware under Federal Rules of Civil Procedure 26-36 (the "Discovery Rules"). From newspapers, television, books or other pop-culture references, many of you are pretty familiar with the initial stages of litigation. In a non-criminal context, litigations start with the filing of a complaint with the Court Clerk's office. Then after a period of time set by the court's rules, defendants have to file an answer to the complaint. (At least that was how it used to work before the advent of electronic filing. Now all the documents are filed online and stored electronically.)

In most jurisdictions, once the answer has been filed, you enter that phase of the case that is never glamorized on TV and rarely shown in the movies, the fact discovery phase. There are two parts to fact discovery. First, there is the paper discovery, consisting of interrogatories, requests for production of documents and requests for admissions. These are questions posed by a party's attorney to the other parties in the case to bring out or "discover" the facts those parties know. Non-parties to the case may be served with a subpoena to obtain documents in their possession pertaining to the facts of the case. Second, a party may choose to conduct depositions of parties or potential witnesses. The subpoena served on a non-party may also require the non-party to appear for a deposition. At a deposition, an attorney will ask another party or fact witness questions under oath. Some of you may have already gone through this wonderful and unique experience.

Back in the stone ages, when computers were not held in the palm of your hand, paper discovery was easy, although time consuming. The attorney posed a question, through an interrogatory or a request for production. You or one of your employees' examined your paper files to find the answer. If you had a piece of paper that answered the specific question posed, you set it aside to give to your attorney, who would then produce the document to the other party in the case. Now, with computers, i-Pones, Droids, Blackberries, texting, e-mail, etc., the places to look for information is daunting. Entire new businesses have popped up to deal with this phenomenon, from forensic computer scientist experts to e-discovery IT specialists.

The new Default Standard, the Discovery Rules and the common law set forth rules requiring parties to preserve their ESI and paper files for the purposes of discovery in litigation. Often, once a party is sued, it is too late for the party to become versed in its own ESI systems to meet the preservation standards. (Are e-mails set to automatically delete or be archived? Once archived, then what happens? Where is archived e-mail stored? How are my computer files backed-up? Etc.) Documents you need to prove your defenses may have been deleted or shredded, or you do not have the expertise needed to recreate them. On the other extreme, the other party accuses you of trying to hide evidence because the documents are lost. The best time to learn about discovery of ESI is well before litigation is even on the horizon. The old Boy Scout motto of "Be Prepared" is applicable for discovery, especially ESI.

An issue that comes up over and over in litigation is destruction of evidence (or spoliation) by a party. The image comes to mind of a darkened room full of paper shredders with people feeding sheets after sheets of paper into them. But, in the electronic age, paper is not the only place people look for information. Having a designated person or team at you company, whether in-house counsel or others knowledgeable in this area will help minimize your costs in the long run when faced with responding to discovery requests. Everything costs more when you have to do it expedi-

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1. THE DEFAULT STANDARD MAY BE FOUND ON THE COURT'S WEBSITE AT WWW.DED.USCOURTS.GOV/ORDERSMAIN.HTM, THEN CLICK ON "GUIDELINES."

Bradley D. Blakeley, Esq.

A New Installment On The "Kiwi Defense" To A Preference Action

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Kimmelman v. Port Authority of New York and New Jersey (In re Kiwi International Airlines). The court determined that if an executory contract was assumed pursuant to a court order, section 547 of the Bankruptcy Code cannot be satisfied. In the *Kiwi* case, creditors that were counter-parties to the assigned contracts received payments as cure under the debtors' defaults under prepetition amounts owed. The court found that, in this situation, payments are not recoverable, since even if these defendants had not received these amounts pre-petition, they would have been compensated similarly when the Bankruptcy Court approved the cure amounts of their assigned agreements.

In a sale of assets, Section 11 U.S.C. § 365 of the Bankruptcy Code affords debtors the opportunity to reject or assume, and then assign executory contracts and unexpired leases to a purchaser. The purpose of this provision is to provide the trustee with a means to coerce vendors to continue trade relations with the debtor during the reorganization process. In order to protect the counterparties to these executory contracts, the Bankruptcy Code requires debtors to cure all outstanding defaults at the time of assumption, compensate the counterparty for actual loss from the default and provide adequate assurance of future payments. But does the Bankruptcy Code provide counterparties to assumed executory contracts any protection with respect to preferential liability? Are pre-petition payments made under an executory supply contract, which was both assumed and assigned by the debtor, liable to recovery under Section 11 U.S.C. § 547(b) of the Bankruptcy Code?

Prior to filing Chapter 11, Fluid Routing Solutions, Inc., one of the debtors, and Almond Investment Company entered into a supply agreement, in which Almond agreed to supply goods and services to the debtor. As of the petition date, the debtors had $518,786 outstanding on this agreement. In the early stages of the bankruptcy, the debtors filed a "sale motion", under which their purchaser, FRS Holding Corporation, was to assume a list of trade payables; the supply agreement with Almond was not initially included.

Despite excluding Almond from the list of trade payables, the debtors attempted to enter into a critical vendor agreement with Almond to ensure a continued supply goods and services to the debtor throughout the reorganization. However, Almond declined this offer, and instead opted to amend their previous supply agreement to condition post-petition supplied goods and services on the debtor making a cure claim of $367,385.57.

After the court approved the "sale motion", the debtors were allowed to sell assets and pay off previous assumed cure amounts, including Almond's claim. Several months later, the case was converted to a Chapter 7, and the trustee sued Almond for the recovery of $1,445,659.77 in alleged preferential transfers under sections 547 and 550 of the Bankruptcy Code. In response, Almond filed its answer and affirmative defenses as well as a motion for summary judgment.

> "IN DETERMINING WHETHER OR NOT TO GRANT ALMOND'S MOTION FOR SUMMARY JUDGMENT, THE BANKRUPTCY COURT LOOKED TO THE *KIWI* DECISION"

In determining whether or not to grant Almond's motion for summary judgment, the Bankruptcy Court looked to the *Kiwi* decision. The Court had the burden of determining whether the contract between Almond and Fluid Routing Solutions was an executory contract, and furthermore, whether it was assumed or assigned by the debtors.

As defined by the Third Circuit, an executory contract is one under which the obligation of both the debtor and the counterparty to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach of contract. According to the supply agreement, Almond agreed to supply parts to the debtors at a specified constant rate for an extended period of time into the future. The supply agreement shows an on-going requirement for sup-

A New Installment On The "Kiwi Defense" To A Preference Action

ply and purchase of parts, deeming it an executory contract.

Bankruptcy courts have held that a contract is not assumed and assigned unless it is specifically listed on the list of assumed executory contracts in the purchase agreement, filed with the sale order (*Litigation Trust v. Alpha Analytical Labs (In re IT Group, Inc.)*). The trustee challenged whether the Almond contract was assumed because it was not listed in the initial list of contracts to be assumed. However, the court found that the supply agreement was attached to the sale order and Almond was specifically included in the amendments to the asset purchase agreement. Furthermore, the sale order expressly references that the Almond "Cure Amount Agreement" is an "Assumed Contract" which the court declared binding and in full force and effect. For these reasons, the court found that the supply agreement with Almond was both assumed and assigned by the debtor.

Due to the Court's findings that the supply agreement between Almond and the debtor was an executory contract, as well as assumed by the debtors and assigned to the purchaser, Almond's motion for summary judgment was granted. The transfers were not avoidable under sections 547 and 550 of the Bankruptcy Code. Lesson learned for creditors – while your contract is not required to be on the list of assumed contracts in the notice of motion, it must be on the list of assumed contracts in the purchase agreement and sale order.

Delaware's Default Standard For Discovery – When To Start Your Preparation

Peter M. Sweeney, Esq.

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tiously for the first time in litigation. High priced attorneys and ESI experts will be involved. Whereas, if you invest early in a good IT person or group, then the cost should be minimized. Whether you are a big corporation and have an in-house IT team or a small company hiring an IT consultant on a per hour basis, it is essential to hire someone with experience in undertaking an ESI investigation.

In consultation with your IT professional, you will need to identify all the places you have stored information that could be the subject of a discovery request. All of your computer hard drives and network servers are just the starting point. Do not forget your phones, i-pads or other tablets, the Cloud, phone records, saved voice mail messages, temporary files, the list is long. Once litigation has been initiated, you or your company will have an affirmative duty to preserve all of the potential sources of information. You cannot preserve the evidence, unless you know where it is potentially stored. Your IT professional or team will be invaluable in identifying all the sources of information.

Next, in consultation with your IT person and your attorney, set a written document retention policy. If you have a company procedures manual (if you don't, you probably should), this should be one of the first chapters. The purpose of the document retention property is to set the dates after which you are free to destroy the documents you are preserving. Federal and state law, as well as common sense, set certain timeframes for retaining documents. There may be a set standard for your industry as well. For example, we all know to retain our tax returns and other financial record for seven (7) years due to the risk of an IRS audit. There may be other industry standard for retaining invoices, bills of lading, delivery tickets, e-mails, databases, etc. Further, with certain programs, your IT person will be able to set parameters for preserving or

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"IT IS ESSENTIAL TO HIRE SOMEONE WITH EXPERIENCE IN UNDERTAKING AN ESI INVESTIGATION"

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destroying information sources. Finally, procedures need to be implemented for backing-up your data on a daily, weekly, monthly and annual basis.

The litigation purpose behind having a written document retention policy is the ability to explain to a Judge why you no longer are in possession of certain documentation. "Well you see, Your Honor, according to paragraph two of our document retention policy found in our procedures manual, we destroyed that document two years ago" is a lot better answer than, "We got sued and shredded the document" or even "I don't know where the document is". Without a document retention policy, set during a time when your company was not under threat of litigation, the Court could view the inability to produce a document as a bias in the other party's favor.

In this computer age, software and hardware become outdated very quickly. A rule of thumb is that computer programs and equipment become outdated every five (5) years. All of a sudden the database you have been using may no longer be accessible because the program is no longer made. So, you might have the information being requested, but it is no longer accessible. A good practice is to keep one computer from the old system around just to have access to outdated information. At the very least, preserve the hard drive in accordance with your document retention policy. Further, your IT group, in-house counsel, or other designated party, should keep a running list of systems that are out-of-date or inaccessible, so that you may provide that information to the Court or other party. Under the Default Standard, you may not be required to search inaccessible systems until the search of all other reasonable sources of information has been completed.

Another part of being prepared is to be careful what you say. E-mail, voice mail, texts, etc., are discoverable, unless subject to some form of privilege, i.e. attorney-client privilege. Plus, just because you delete an e-mail or other document, does not mean the document is gone forever. Always assume that what you are saying or writing could end up in front of a judge or as evidence. Do not be the insurance company executive from the Matt Damon movie *The Rainmaker*, who wrote a letter to its dying customer calling him "Stupid, stupid, stupid."

You have prepared the best you can and now find yourself in the discovery stage of litigation, now what?. According to the Discovery Rules and Default Standard, the parties' attorneys are to engage in a discovery conference to discuss: "(i) The issues, claims and defenses asserted in the case that define the scope of discovery, (ii) the likely sources of potentially relevant information, including witnesses, custodians, and other data sources (e.g., paper files, email, databases, servers, etc.), (iii) technical information including the exchange of production formats, (iv) the existence and handling of privilege information, and (v) the categories of ESI that should be preserved." See Fed. R. Civ. P. 26 and the Default Standard. The information you prepared on your computer systems will now be invaluable to your attorneys at this conference to define and limit the scope of discovery.

Considering the cost burden of unlimited discovery of ESI, Delaware set the Default Standard to limit the discovery by instituting a reasonableness standard. The Default Standard sets forth how images of documents shall be produced (text searchable image files, e.g. PDF or TIFF), the extent of the metadata to be included with the documents (e.g., file path, date sent, email subject, etc.) and other parameters. Parties can always agree to adjust the Default Standard as necessary for a particular litigation. If the parties cannot agree on such changes, then the Default Standard is there to set the floor for discovery of ESI. Consulting with your attorney and IT personnel prior to any litigation will assist you in keeping the costs of the discovery in check.

Supreme Court To Resolve Circuit Split On Secured Lenders' Credit-Bid Rights In Chapter 11 Plan Sales: Consequences For Secured And Unsecured Creditors

David Mannion, Esq.

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lenders with means to protect themselves from the risk that the winning auction bid will not capture the asset's actual value…This protection is important since there are number of factors that create a substantial risk that assets sold in bankruptcy auctions will be undervalued." 651 F.3d 650-651. According to the Court, those factors include: (1) the timing of bankruptcy auctions and corresponding limitations on the ability to market estate assets; (2) the risk of self-dealing on the part of management; (3) the limited availability of credit in the current economic climate; and (4) the fact that bidders will usually reduce their bid in an amount commensurate with their transaction costs, thereby decreasing the likelihood an asset's sale price will reflect its actual value. *Id*.

More importantly, however, unless a secured lender has the right to credit-bid it is hard to argue that it can ever receive the "indubitable equivalent" of its collateral. As noted by the Third Circuit, "'[i]ndubitable equivalent' is not defined in the Code, but there can be no doubt that the secured creditor receives consideration equal to its claim in value or amount." *In re Phila. Newspapers, LLC*, 599 F.3d 326 (*citing* Webster's Third New Int'l Dictionary 1154 (1971) (indubitable means 'not open to question or doubt' or 'too evident to be doubted'); id. at 769 (equivalent means one that is 'equal in force or amount' or 'equal in value'").

In this writer's opinion, any interpretation of § 1129(b)(2)(A) that denies a secured lender the right to credit-bid effectively deprives it of the ability to exercise its business judgment. It is submitted that the unfettered ability to exercise business judgment, for better or worse, should be considered to be an inextricable component of receiving the "indubitable equivalent" of one's collateral. If a secured lender wants to take ostensibly outlandish financial risks by repossessing collateral under circumstances where valuation experts testify that the property is worth less than the credit-bid, it should be allowed to do so.

As far as unsecured creditors are concerned, Judge Ambro's position that credit-bidding maximizes the value of estate assets is convincing. However, even assuming this to be true, it does not address the question of whether unsecured creditors will benefit as a result. As an abstract proposition, unsecured creditors always have an interest in the maximization of the value of estate assets and the reduction of deficiency claims. However, the treatment of unsecured creditors under a Chapter 11 plan is often unrelated to whether a credit-bid generates more value for the estate than the next highest cash bid because unsecured creditors will often agree to support or oppose a credit-bid in exchange for pre-determined assurances as to their treatment under the plan.

> "UNLESS A SECURED LENDER HAS THE RIGHT TO CREDIT-BID IT IS HARD TO ARGUE THAT IT CAN EVER RECEIVE THE "INDUBITABLE EQUIVALENT" OF ITS COLLATERAL"

The interest of the *Philadelphia Newspapers* Creditors' Committee in the secured lenders' credit-bid rights was explained by the Committee as follows: "the Debtors' Plan provides a *de minimis* distribution to unsecured creditors, whereas a credit bid from the Prepetition Lenders is likely to result in a far better result for unsecured creditors…The Prepetition Lenders…have the ability to make a bid that provides for an increased equity distribution to unsecured creditors, provide minority shareholder protections and waive the Prepetition Lenders' rights to receive a substantial part of the [general unsecured creditor] pool that otherwise would go to them on account of their deficiency claims. The Prepetition Lenders have agreed to these very substantial benefits for unsecured creditors if they are able to acquire the companies via a credit bid." (*see* 3d Cir.; Case No.: 09-4349; Comm. App. Br. pp. 22-23).

However, under different circumstances unsecured creditors might just as easily be found

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Supreme Court To Resolve Circuit Split On Secured Lenders' Credit-Bid Rights In Chapter 11 Plan Sales: Consequences For Secured And Unsecured Creditors

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arguing that credit-bidding undervalues estate assets and hurts their recovery. Indeed, in distinguishing *Pacific Lumber*, 584 F.3d 229 (5th Cir. 2009) – on which the *Philadelphia Newspapers* majority ultimately relied – the Creditors' Committee argued that *Pacific Lumber* "illustrates that bad facts often make bad law. The Pacific Lumber court was faced with two competing plans – one a heavy handed attempt by one group of secured creditors to favor themselves to the detriment of all other constituents via a plan that was clearly neither confirmable nor supported by any other constituent, and the other a plan that provided for substantial distributions for all creditors and was widely supported." (Committee App. Br. at pp. 45-46 *citing Pacific Lumber*, 584 F.3d 250-252).

Conclusion

In the final analysis, it is self-evident that a secured lender cannot fail to benefit from having the *option* to credit-bid when its collateral is being sold free of liens under a plan. However, to return to the question posed earlier, do unsecured creditors benefit merely by being exposed to the possibility that a secured lender is free to exercise that option? It is submitted that the answer, at least in the Third Circuit, will depend on the structure of the credit-bid and what value unsecured creditors can extract from other constituencies in exchange for supporting or opposing it. However, it is this writer's prediction that the Supreme Court will agree with the Seventh Circuit that secured lenders have a statutory right to credit-bid when their collateral is being sold free of liens under a plan. If that happens, then secured creditors will have no need for the support of unsecured creditors when it comes to exercising their credit-bid rights. In other words, if the decision of the Seventh Circuit in *River Road* is affirmed, then unsecured creditors will have one less bargaining chip at their disposal.

Are You Jeopardizing The Collectability Of Your Accounts With A Stale Guaranty?

Johnny White, Esq.

(Continued from page 3)

sponsibility.

A related problem can arise in the context of mergers and acquisitions. Ownership of accounts is changing hands, and unless the credit department, as a matter of policy, requires all the newly acquired customers to sign fresh guaranties, problems can arise. In fact, whether a company succeeds to a guaranty by merger or by acquisition may be an important distinction depending on the governing state law.

The merger is usually not problematic. When a merger takes place, one of the two merging companies is extinguished, and the newly merged company succeeds to the rights of the now defunct old company by operation of law. The legal effect has been described as "not creat[ing] an entirely new entity but 'merely direct[ing] the blood of the old corporation into the veins of the new, the old living in the new'" *Jackson v. Continental Telephone* Co., 212 Cal.App.2d 514 (citation omitted). However, when a company is acquired, e.g. by a bulk purchase of assets, the old corporation is not extinguished. It still exists, and a guaranty in favor of the selling company may still run in its favor, rather than the successor-buyer, especially where the seller continues to operate in some fashion. To succeed to the guaranty in this context, it

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Are You Jeopardizing The Collectability Of Your Accounts With A Stale Guaranty?

would have to be validly assigned. In some states, whether this can even legally occur will be dependent on an archaic common law distinction between "general" and "special" guaranties.

So You Think You're Special…

As noted above, the law of guaranties varies from state to state. In certain states the law has been substantially impacted by legislative enactments. In others, it is primarily judge-made and old common law rules, such as the rule relating to "general" and "special" guaranties, survive.

Traditionally, a general guaranty was one addressed to all persons generally, e.g. "To whom it may concern, I hereby guaranty…" A special guaranty, on the other hand, was addressed to a specifically-named person, and enforceable only by that specifically-named person. Under common law rules, a special guaranty could not be assigned unless the guaranty explicitly stated that it could. While the question is infrequently litigated, cases applying the distinction remain good law in states such as Delaware, Missouri, and Florida. The practical effect is that if your company bought the assets of a Florida-based company, and was assigned its customer accounts, the personal guaranties associated with those accounts are likely unenforceable if the original credit application or guaranty contained a Florida choice of law clause, and the guaranty specifically named your predecessor.

The position is different in states such as California, where there are specific code provisions making guaranties presumptively assignable, and Illinois, which analyzes whether assignment materially altered the obligations imposed on the guarantor. One Illinois federal court decision pragmatically recognized that "[t]he decision to effect a consolidation of two businesses…is ordinarily based on business and tax considerations which are irrelevant to the question whether a guaranty issued to one of the predecessor businesses should survive" *Essex International, Inc. v. Clamage*, 440 F.2d 547, 550-551 (7th Cir. Ill. 1971) However, even suing for enforcement of guaranties in those states does not fully insulate you from the common law hangover of the special/general distinction. As long as the guaranty (or credit application) contains a choice of law clause from a state that dogmatically respects the special/general distinction, that choice of law should govern, and the rule would apply.

General Pointers

The most practical advice that can be offered to any large credit department faced with the kinds of issues outlined above is to simply require all of your customers to re-execute their personal guaranties periodically, either after a defined period of time, or after a customer's credit limit goes above defined thresholds. While you will no doubt encounter resistance from sales, the arguments in favor of doing so appear far more persuasive, especially if you are a large company not in desperate need of every sale. It can be presented to the customer as a matter of company policy, which eliminates any suggestion of distrust, and if the customer refuses to sign a personal guaranty that is a reason in its own right to reassess whether it should be extended credit. The argument against doing so appears to be either that you risk souring the sales relationship, or that you risk the customer revoking his existing guaranty which he may have forgotten about. If the latter motivation is what gives you pause, remember that the existing guaranty should not be assumed to be bulletproof.

"REQUIRE ALL OF YOUR CUSTOMERS TO RE-EXECUTE THEIR PERSONAL GUARANTIES PERIODICALLY"

Logged Off: Your Technology Company Customer May Soon Be Insolvent

Scott E. Blakeley, Esq.

(Continued from page 1)

ing cash reserves, face losses and fierce competition, and experienced tightened loan requirements from venture capital firms. Add to this gyrating share prices and marginal technology companies are failing to meet their trade debt.

The Insolvent Technology Company

The assets of a technology company comprise intangible assets, generally the intellectual property of a domain name and customer list. A technology company's value is usually not based on its revenue. Technology companies are commonly financed through venture capital and vendor credit. However, some technology companies are running low on cash, and have found that they can not count on additional funding from investors. When a technology company's funding is cut off, the technology company often desperately searches for a buyer of the business as a going concern. The insolvent technology company shuts its door without paying its debts, finds a buyer or takes cash at any price so as to keep the doors open. When a technology company suffers from a cash crunch (and declining stock price if public), it faces grave difficulties holding on to key employees – many of whom choose employers based on stock option plans. If unsuccessful, the technology company usually liquidates, without paying vendors.

A technology company does not fare well after Chapter 11 bankruptcy. A technology company bankruptcy results in a sale of the company's business. While most technology companies have few assets beyond their domain name, some may possess technology licenses or real estate that competitors or vulture buyers may want.

Reducing the Default Risk of a Credit Sale to a Technology Company

As the credit professional is aware, few technology companies have profits or meaningful tangible assets, and traditional credit scoring may not accurately measure risk of non-payment with a credit sale. The stock market may be a better method for measuring the technology company's financial strength and ability to repay a credit sale.

Given the technology company shakeout and speculative value of a technology company's assets, along with its dependence on third party investments and/or financing and little or no cash flow, a creditor assumes a significant risk of non-payment.

"A VENDOR MUST ACT QUICKLY IF THE TECH CUSTOMER FAILS TO PAY ACCORDING TO TERMS"

A credit professional may consider taking collateral, personal or corporate guarantees, letters of credit, to back up the immediate credit risk, until the technology company has a steadier stream of revenue. The credit professional may also consider accepting payment by a credit card with the commercial sale.

In the event the credit professional does not have an alternative source for payment for the technology company credit sale, a vendor must act quickly if the tech customer fails to pay according to terms. A creditor may consider immediately commencing a lawsuit upon a technology company's failure to pay according to invoice, coupled with an application for writ of attachment, out of concern that the debtor's assets, especially cash, are fleeting.

If the technology company is proposing to sell all of its assets, including inventory outside of bankruptcy, the buyer must comply with the state's bulk sale laws, if enacted. If the buyer fails to comply with the bulk sales law, the buyer may be liable for the vendor's delinquent account.

Is Your Hedge Fund-Financed Technology Customer Able To Pay For The Credit Sale?

As suggested previously the primary source of capital for the technology company is venture capital as well as vendor credit. As the Wall Street Journal reports, there is no question that the start-up financing market is getting weaker and weaker by the day. While scores of Web companies were founded in recent years, there is not nearly enough venture capital to keep all of them going indefinitely. The aver-

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age valuations of young companies have dropped recently to $3 million to $5 million, from $6 million to $8 million earlier this year. For this exact reason, many small technology companies, who may previously have had ambitions to stay independent, now are more interested in selling themselves at a more reasonable price.

Internet start ups, web-based and technology companies, such as social networking site Linked-In, are making headlines with record initial public offerings, as well as companies like Groupon and Facebook that are on the verge of IPO's. The technology companies that are not prepared for the IPO stage, are finding hedge funds (HF) and venture capitalists (VC) pouring billions into these technology companies, many of them at the startup stage. The investment strategy of the HF and VC is to often provide the seed money at the startup stage, perhaps put in an additional round or two of financing, and cash out through an IPO or when the technology company is sold. If the HF or VC is financing the technology company, rather than investing in the company, the financing terms provided by the HF or VC are often comparable to traditional forms of financing. The HF and VC expect high returns, which may result in an overleveraged technology company; in turn that means greater risk of default on vendor's invoices.

HFs and VCs don't anticipate profits immediately from their technology investments. However, HFs and VCs are restless with their technology company investments when they don't meet projections. In today's economic climate where double dip recession has been raised, technology companies that have burned through operating cash reserves and are facing losses and fierce competition are dealing with tightened investment requirements from HFs and VCs. This may result in a failure to pay vendors.

For the vendor selling to the technology company it must be understood that the capital structure is not like a brick-and-mortar enterprise that relies on bank financing or internal financing to operate. Banks and asset-based lenders generally do not offer financing to the technology companies because of their limited operating history and lack of tangible assets to secure the financing.

When a technology company's funding does evaporate, it often desperately searches for a buyer of the business. The insolvent technology company either: shuts its door, finds a buyer or takes cash at any price, and vendors commonly go unpaid. Technology companies have even found their creditors suing to halt their cash burn rate in hopes of preserving assets to pay debt.

Assets to Pay Vendor's Invoices?

The value of most technology is intellectual property, such as customer lists, licensed technology and engineering teams. In analyzing whether to sell the technology company on open terms of credit, the credit professional must consider different credit criteria than that of a company whose primary assets may be tangible in nature (bricks and mortar). Excess cash burn rate is often the benchmark to determine whether the technology company has assets available to pay for the credit sale. However, given that the foundation of a technology company's value (technology and engineering teams) is constantly evolving, with some technology becoming obsolete or no longer popular, a credit professional providing goods or services to the technology company can not necessarily look to the HF and VC to provide an additional round of financing as a source to pay the vendor's open invoices. Indeed, HFs and VCs may view the current technology investment market as overpriced, as was the case of the dot-coms in the 2000's. This may mean it is harder than ever for certain technology companies to obtain additional affordable financing, or a buyer and, with that, harder to pay the vendor.

No Assets Available for Vendors with Liquidating Technology Co.

A number of initially well-funded technology companies have closed their doors, and auditors for some technology companies have is-

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sued warnings that the tech company's survival is in "substantial doubt." Technology company liquidations are growing for some sectors, and a technology company's liquidation yields little for vendors. Indeed, a technology company's market value bears little in a value liquidation.

While a bricks-and-mortar company may have tangible assets that will allow it to reorganize should it run into financial difficulty, technology companies do not fare as well. The technology company that cannot obtain an additional round of financing simply disappears. While a bricksand-mortar company may find a buyer for its assets, a technology company usually does not have such an opportunity. A technology company's assets are liquidated at a fraction of their going concern value.

Analyzing Cash-Burn Rate

A tech company usually does not generate profits or have meaningful tangible assets, and traditional credit scoring may not be an accurate measure of risk of non-payment on a credit sale. With a publicly traded technology company, the stock market may be a method for measuring its financial strength and ability to repay its vendors. Given the HFs and VCs reluctance to provide additional financing to a technology company, the credit professional must analyze the excess cash burn rate more closely than ever. The cash burn rate is determined as the amount by which a technology company's expenses exceed its cash flow. Start-up technology companies often raise a year's worth of cash to operate at a time. The adage "cash is king" seems especially true for a technology company, given their lack of alternatives to finance operations. To determine how long cash may last, and the prospects for payment on a credit sale, the credit professional may divide the technology company's burn rate by the amount of cash it has. If the technology company is publicly traded, the credit professional may look to the quarterly burn rate. A high burn rate will result in the technology company unable to finance operations and repay vendors.

Obtain Financials for a Burn-Rate Analysis

In addition to funding delays, technology companies may be receiving less HF and VC funding than projected and the funding may be dispersed incrementally based on milestone accomplishments. To that end, the vendor should consider insisting that the technology company provide the status of HF and VC funding, especially if the tech customer places a large order. The vendor can offer a nondisclosure agreement as an incentive for the technology company to provide the funding milestones. The vendor can also request that the technology company disclose a bank reference reflecting where the HF or VC funding is maintained .The vendor also has the option of requesting that the HF or VC furnish a guaranty to back the vendor's credit sales. In that case, should the technology company default, the vendor may call on the HF or VC to pay for past due invoices.

Still Opportunity for Sales

With concern of a double dip recession, HF and VC funding may pull back. Given this, a technology company's cash-burn rate is key to any credit analysis.

Are Those Really Assets (Customer Information and License Agreements) On Your Technology Company Customer's Balance Sheet?

Your computer monitor flashes with an e-mail from the regional sales manager, where she proclaims landing a mid-six figure sale to a new customer. The customer is a technology company. With little financial and operating history, as well as tangible assets, the technology company appears a significant credit risk and a candidate for cash-in-advance or using a credit enhancement. With the credit professional wearing the hat of relationship builder, the credit professional takes a closer look at what comprises the technology company's value.

In determining whether to extend credit to a

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technology company, one step a credit professional may take is analyzing what comprises the value of the technology company. As mentioned previously, unlike the a "brick-and-mortar" company whose primary value is created through tangible assets such as inventory, real estate and FF&E, a technology company's primary value is usually created through intangible assets and intellectual property rights, such as licensed technology and customer lists or information.

But what is the real value of these intangible assets, especially should a technology company run into financial trouble? Do these intangible assets have a meaningful liquidation value that a credit professional may look to if the technology company fails to pay its vendors? What legal restrictions may a technology company face with a proposed sale of its intellectual property assets in a bankruptcy?

Technology companies, whether distributors or e-tailers, now proliferate the business community and provide a new opportunity for sales for vendors. Generally, a technology company is financed through venture capital or owner investments, and is often free from creditors claiming a lien on all assets. This means that a vendor has the first bite at the assets of a financially struggling technology company, as the owners' shareholder interests are junior to vendors' claims. This article considers two of the most commonly listed assets on a technology company's balance sheet, customer information and licensed technology, and the prospects of their value when a technology company runs into financial trouble.

Maximizing Value of Insolvent Technology Company v. Privacy Rights: Is Customer Information an Asset?

Frequently, the most valuable asset held by a technology company selling to consumers is information regarding its customers. Technology company customer lists may be valuable to the technology company's competitors as the customer lists also can contain information concerning a customer's buying preferences, names and ages of children, credit card numbers, birth dates, and other information which customers may not wish to disclose to third parties. For years, brick-and-mortar companies have sold their customer lists as assets in bankruptcy proceedings without objections by government agencies. However, due to the detailed nature and confidentiality of the customer information compiled by the technology company and the potential value of this asset in relation to other assets of the technology company, its treatment in a bankruptcy may bring conflicting interests with creditors.

Whether a technology company may dispose of a customer list as an asset, especially if the technology company has entered into an agreement with a customer that pledges privacy may be critical in determining the liquidation value of the technology company. There is no federal law that prohibits such a sale. However, a technology company may encounter opposition in trying to sell its customer list, where privacy was promised by the debtor when the customer information was collected.

The FTC may sue a debtor for deceptive trade practice, alleging that in attempting to sell a customer list when a debtor is breaking its posted privacy policy and violating fair trade practices. Using its police powers, the FTC can file a lawsuit against a debtor claiming that the debtor misrepresented to its customers that personal information would never be shared with third parties.

For instance, the FTC sought an injunction on the sale of any customer data by Toysmart, an online toy store that went into bankruptcy, during its proposed liquidation sale. The FTC cited Toysmart's privacy policy, which stated that Toysmart would "never" disclose this information to any third parties, as grounds to prevent the sale.

Another instance of FTC intervention in the sale of customer information can be seen in the widely publicized liquidation of Borders Group Inc. In this particular case, the director

"WHAT IS THE REAL VALUE OF THESE INTANGIBLE ASSETS, ESPECIALLY SHOULD A TECHNOLOGY COMPANY RUN INTO FINANCIAL TROUBLE?"

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"IF A TECHNOLOGY COMPANY WITH LICENSED TECHNOLOGY RUNS INTO FINANCIAL DIFFICULTY, A BANKRUPTCY MAY NO LONGER BE AN ALTERNATIVE"

of the FTC's Bureau of Consumer Protection, David Vladeck deemed the Border's privacy policy to be insufficient to notify its customers of the possibility of a sale of customer information in the case of a bankruptcy.

The FTC's intervention in sales of a technology company's assets has caused significant changes in the wording of privacy policies. Now, many privacy policies include specific provisions that allow the sale of customer lists in situations such as liquidations, acquisitions and bankruptcies.

The risk of government intervention with a debtor's sale of its customer list highlights the conflict of interest between privacy concerns on the one hand and creditors' interests on the other, and underscores the need for the credit professional to question whether a customer list indeed has meaningful value and is an ultimate source of payment in the event of a debtor's insolvency. Vendors, of course, have an interest in ensuring that the proceeds of a sale of the customer list are maximized, and the technology company's officers have a fiduciary duty to maximize the value of assets by selling assets and distributing the proceeds to creditors. A customer list is often one of the few assets of an insolvent technology company whose customer base is consumers that may be sold.

However, consumer privacy rights and the Internet are of significant concern for the U.S. Congress, state legislatures and state and federal regulatory agencies. Some technology companies have appointed a chief privacy officer, whose responsibilities include setting privacy policies, and keeping track of information the technology company collects and disseminates.

What Rights Does a Technology Company Have to Licensed Technology in a Bankruptcy?

A credit professional should investigate whether the technology company owns the technology that makes it unique or, rather, licenses the technology from the owner. For some technology company's, a significant part of their value is tied to licensed technology. If the technology company that has licensed technology is forced to file bankruptcy, the technology company may be required to get authorization from its licensor to use or sell the patented technology. Without the patented technology the technology company may have little value and will not survive in bankruptcy without the consent of the licensor.

Thus, if a technology company with licensed technology runs into financial difficulty, a bankruptcy may no longer be an alternative, or a threat to a vendor, as the technology company may not be able to reorganize in bankruptcy without the licensed technology. The technology licensor may have significant leverage over the insolvent customers, who may have the legal right to take control of the technology company by refusing to allow assumption of the technology license. Given this, the vendor selling on credit to the technology company, whose primary asset is licensed technology, may face considerable risk that the technology company may not have an asset to generate income (and pay vendors) if it runs into financial difficulty without the consent of the licensor.

The Risk of a Credit Sale to a Technology Company

technolmpany's assets are likely to be focused on intellectual property rights. Whether these intangible assets of an insolvent technology company may be sold to pay vendors' claims is still emerging. As part of a best practices protocol with a credit and collections policy and selling to a technology company, the credit professional may consider a number of questions regarding what comprises the value of a technology company and how the vendor may be paid in the event the technology company runs into financial difficulty, such as: If the technology company you are selling have consumers as a customer base, does the technology company's website have a privacy pledge? Can the intellectual property be legally transferred? How long ago was the tech-

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nology company's intangible assets valued, given the speed in which a technology company's assets may depreciate? Is there a market for the intangible assets, if the technology company is forced to sell?

Given the speculative value of a technology company should it run into financial difficulty, the vendor might look to have the technology company, or a third party, post assets or promises to secure the sale.

Guarding Your Sales to the Technology Company with Credit Enhancements and Alternative Payment Mechanisms

Liquidation is a growth industry for technology companies and the vultures of the Internet are arriving. A number of liquidators are now specializing in buying a failed technology company's inventory at a steep discount and reselling the goods on the Internet. Bankruptcy trustees, too, have been buoyed by the technology company bust as they auction off the technology companies' remains over the Internet. Creditors have learned a painful lesson that there are few assets to pay vendor claims from an insolvent technology company. Given the recent volatility of technology companies, a credit professional must now consider alternatives to a credit sale to that kind of customer; but the credit professional also appreciates that demanding a cash sale may mean losing the sale. What credit enhancements or alternative payment mechanisms are available to protect the vendor in the event that the technology company fails to pay?

Looking for Guaranteed Payment

The vendor is looking for the credit enhancement that is most readily converted into cash, and is unlikely to be affected by an out-of-court liquidation or bankruptcy of the technology company. The following is an outline of such credit alternatives:

Letter of Credit

A letter of credit (L/C) is a promise by an issuer, the bank, to pay the vendor, as beneficiary, when the technology company has defaulted on the sale. The technology company uses its assets as collateral for the L/C, so that the credit of the bank is substituted for the credit of the technology company in favor of the creditor. The technology company pays the issuing bank a fee to issue the L/C. If the creditor submits proper documents upon default, the bank will pay the L/C and the technology company reimburses the bank. An L/C may be either revocable or irrevocable. An irrevocable L/C can be modified only with consent of the creditor. A revocable L/C can be modified by the bank without the consent of the creditor. The creditor can obtain a standby L/C, which assures payment after the technology company's default. The creditor should insist on an irrevocable L/C with the technology company sale.

L/C's are independent from the underlying contract between the technology company and the creditor. The bank honoring the L/C is concerned only to see that the documents conform to the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the technology company. The bank need not look past the documents to examine the underlying sale of goods. Thus, a creditor is given protections that the issuing bank must honor its demand for payment (which complies with the terms of the L/C), regardless of whether the goods conform to the underlying sale contract. The amount of the L/C should equal the amount of the line of credit.

The L/C's independence of contracts may allow a creditor to avoid the effects of a technology company's bankruptcy. Bankruptcy courts recognize that the proceeds of a letter of credit are not property of the technology company's bankruptcy estate, and that a bankruptcy court does not have authority to bar payment under a L/C, notwithstanding the effects of the automatic stay. The creditor may insist on an L/C that provides for the maximum exposure under the credit line. For example, if the creditor manufactures goods specifically for the customer, the goods that are in process yet not billed to the technology company

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should be included in the amount of the L/C.

Certificate of Deposit

A CD may be issued by the technology company's bank in the name of the creditor. The CD is unconditionally payable to the creditor upon demand, is funded by the technology company, and automatically renews for the length of the credit line. The principal amount accrues to the benefit of the creditor, and interest is paid to the technology company.

Credit Insurance

A creditor purchases credit insurance (CI) to avoid loss on a speculative customer, but keeps the accounts receivable. CI may cover a variety of credit risk, from a technology company's bankruptcy, a default or dispute. The CI generally covers up to 90% of the insured account. The risk premium for CI may be measured by the creditor's accounts receivable risk profile. The credit insurer may monitor the buyer's financial condition. The term of the policy may be one` year.

Bankruptcy Swap

Like credit insurance, a creditor may purchase a bankruptcy swap to reduce credit risk but keep the account receivable on the books, unlike factoring where the account may be sold. A swap involves a third party that investigates the credit quality of the buyer of goods. Swaps are common with commercial banks and investment banks that look to diversify their credit risk. The creditor pays a periodic fee for the swap. Unlike credit insurance, the swap can be sold over the market. The buyer of the swap pays the creditor only in the event the technology company files bankruptcy. The swap provides the creditor some protection against a technology company's bankruptcy.

Factoring

Factoring provides for the creditor to sell its technology company account receivable at a discount to a third party, the factor, who is usually a financial institution. The sale is often nonrecourse, which means that the factor is responsible for the technology company account in the event of default. The creditor usually invoices the technology company but the invoice is payable to the factor's address. The creditor sends the invoice to the factor, who pays the creditor a discounted amount of the invoice.

Guarantee

A guarantee, whether corporate or personal, is not the preferred credit enhancement, as it may require the creditor to take legal action to get paid when the technology company fails to pay. However, a guarantee may be used as leverage by the creditor to force the technology company to pay by threatening to pursue the guarantor, who may be a principal of the technology company. Technology companies are often financed by deep-pocketed venture capitalists. If the creditor is a key supplier of the technology company, the creditor may look to the venture capitalist to guarantee the sale.

The basic legal principle is that the guarantor is not a party to the principal debt, the customer that receives your products or service on terms however is. The guarantor's undertaking is independent of the technology company's (your customer) promise to pay. Merely because both contracts are on the same paper, for example, the credit application (in that the technology company's promise to pay for the creditor's goods or services, and the guarantor's promise to pay if the technology company does not) does not change the independence of the agreements.

The guarantee should include a statement that the signing party is personally guarantying the debt of the technology company referenced in the credit application. The guarantee should have under the signature block a line for the individual guarantor's social security number and a line for the individual guarantor's home address. The guarantee should be signed before a notary to reduce the risk that the guarantor may contend that the guarantee was forged.

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Purchase Money Security Interest

Your company as the seller may consider taking a security interest in the goods it sells to the technology company as well as the proceeds from the sale of the goods. Under Article 9 of the Uniform Commercial Code, for the creditor to obtain a valid purchase money security interest (PMSI) in the goods it sells to the technology company a multi-step process must be complied with. The technology company first executes a security agreement describing the goods covered in favor of the creditor, which gives the creditor a security interest in those goods. The creditor perfects the security interest by adequately describing the goods when it files a financing statement with the filing office (usually the Secretary of State).

Your PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the technology company receives possession of the goods; and (2) you give written notice to any other pre-existing inventory secured creditor. If you fail to perfect the PMSI, including giving notice, your priority is governed by the "first to file" rule. This means that an inventory secured creditor will prime your PMSI.

Some problems with a PMSI can be: It requires the consent of the technology company, it may require the consent of the technology company's lender, it can be complicated to properly perfect and it can be cumbersome for the creditor frequently selling in small lots.

Consignment

Article 9 of the UCC's perfection requirements provides the means whereby a supplier can establish a valid security interest in its own inventory, even when that inventory has been delivered to the technology company. The supplier's compliance with the perfection requirements of the UCC not only protects ownership of inventory; in the event of a dispute over the goods, the supplier will prevail over a competing creditor.

An agreement is executed describing the relationship of the parties involved (i.e., the supplier owner is consignor and the technology company seller is consignee); a description of the inventory; and agreement that title to the merchandise only passes to third-party buyers. Then the supplier completes a UCC-1 financing statement, which again describes the inventory and makes clear that the inventory is delivered on consignment. The supplier then files the statement with the filing office (usually the Secretary of State).

A supplier must give notice to any creditor asserting a security interest in the technology company's inventory in order to avoid any appearance that inventory coming to the technology company is free from ownership claims. To have priority in the accounts receivable generated by the sale of consigned goods, the supplier must also comply with the UCC notice-filing requirements as to accounts receivable.

Like PMSI, some problems with a consignment can be that it requires the consent of the technology company, can be complicated for the supplier to properly perfect and can be cumbersome for the supplier frequently selling in small lots.

Alternative Payment Mechanisms When Technology Company Cannot Furnish Credit Enhancement

The technology company and the Internet are not only changing the way creditors bring their goods to market, but also they are changing the way in which creditors may be paid on their sale. A creditor may turn to credit cards and e-payments where a credit enhancement is unavailable or not workable.

Credit Card

Payment by credit card is appealing to the creditor as it allows for payment prior to goods being released to the technology company. However, a creditor may risk charge-back of disputed balances. The technology company's credit card company is not obligated to verify whether the dispute is legitimate. The creditor may also be responsible for

"A SUPPLIER MUST GIVE NOTICE TO ANY CREDITOR ASSERTING A SECURITY INTEREST IN THE TECHNOLOGY COMPANY'S INVENTORY"

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unauthorized purchases and fraud. A creditor may accept a personal credit card for a commercial sale; however, it may be an indicator that the company the person is purchasing for is in financial trouble. However, it may mean that the person wants the frequent flyer miles. Credit card transactions conducted by telephone, fax or the Internet, also known as card-not-present transactions, have a higher risk of fraud.

Credit Enhancements or E-Payments Can Make the Technology Company Sale

Credit professionals are working ever more closely with the sales force and management to make the credit sale, but attempting to have the appropriate measure of risk safeguards to avoid the downside of a customer's insolvency. The key to a credit enhancement is to structure the instrument so that the creditor will maximize the recovery upon a technology company's liquidation or bankruptcy. By tailoring the appropriate credit enhancement or alternative payment mechanism to the credit transaction, the credit and sales teams can maximize sales and minimize risk.

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He was selected as one of the 50 most influential people in commercial credit by Credit Today. Credit Research Foundation has published his manuals entitled The Credit Professional's Guide to Bankruptcy, Serving On A Creditors' Committee and Commencing An Involuntary Bankruptcy Petition. Scott has published dozens of articles and manuals in the area of creditors' rights, commercial law, e-commerce and bankruptcy and speaks frequently to credit industry groups throughout the country regarding these topics. He is a member on the board of editors for the California Bankruptcy Journal, and is co-chair of the sub-committee of unsecured creditors' Committee of the ABI. Scott holds an B.S. from Pepperdine University, an M.B.A. from Loyola University and a law degree from Southwestern University. He served as law clerk to Bankruptcy Judge John J. Wilson.

Blakeley & Blakeley LLP practice covers creditor's rights, bankruptcy, and corporate litigation with their main office in Orange County and satellite offices in New York City, San Francisco, Delaware and Los Angeles.