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Recent Developments in Commercial, E-Commerce and Bankruptcy Law of Interest to the Credit and Financial Professional

FEDERAL COURT RULES THAT EQUAL CREDIT OPPORTUNITY ACT GOVERNS BUSINESS CREDIT

Scott Blakeley

Federal statutes enacted to govern consumer transactions have recently been extended to commercial, or business, credit transactions, as shown recently by the Federal Trade Commission's recent opinion concerning the Fair Credit Reporting Act, and a federal court made that point in a decision involving the Equal Credit Opportunity Act (ECOA). A federal judge recently ruled that ECOA governs business credit as well as consumer credit. ECOA is a federal statute that prohibits credit grantors from discriminating in the granting of credit based on prohibited basis, and requires creditors to comply with certain notifications, and retain records. How does ECOA impact a credit professional's commercial credit decision

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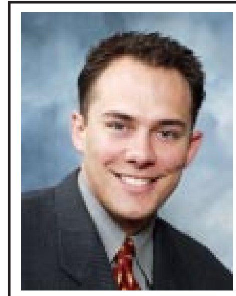
ARE YOU A CRITICAL TRADE VENDOR THAT MERITS IMMEDIATE PAYMENT ON YOUR PREPETITION CLAIM IN CHAPTER 11?: AN UPDATE ON THE NECESSITY DOCTRINE

Richard Ruszat



The faces of chapter 11 debtors are changing. Although "second chance" *insolvent* debtors will always clutter the court's docket, *solvent* debtors are also finding that bankruptcy law works to their advantage. These debtors seek protection for a variety of reasons that include posturing for a sale of the business, trimming unprofitable ventures, or handling massive liabilities. For example, the reorganization of a dominant movie theater chain has been criticized for using bankruptcy law to trim leases and posture itself for a more profitable sale. Similarly, mass tort litigation offers another illustration of businesses using bankruptcy law to their advantage. Mass tort litigation has forced corporations in the asbestos and silicone implant industries into bankruptcy and threatens the tobacco industry and certain tire manufacturers. In filing bankruptcy, these businesses realize that the bankruptcy system offers a unique structure to manage multiple liabilities while at the same time providing an opportunity for their operations to remain profitable. However, many vendors are startled that these solvent, profitable businesses, file for Chapter 11 protection.

A noted effect of Chapter 11 bankruptcy proceedings is that payments on vendors' prepetition unsecured claims are placed on indefinite hold without accumulating interest. Additionally, when payment on unsecured claims is received on the effective date of the reorganization, it is a *pro rata* distribution, often of an insignificant fund. Indeed, it is not uncommon for vendors to be paid through a confirmed plan of reorganization with stock in the debtor's reorganized business. Accordingly, if a vendor seeks immediate payment on its unsecured claim, it must position itself as a necessary, critical component of the debtor's ongoing operations. This article discusses the immediate payment of certain vendors' prepetition unsecured claims in Chapter 11 bankruptcy under the "Necessity Doctrine."

The Necessity Doctrine: Common Law and the Bankruptcy Code

Generally, the Bankruptcy Code ("Code") requires that payment on a debtor's prepetition, unsecured, non-priority claims should be made only through a confirmed plan of reorganization. However, the Necessity Doctrine, a judge-made exception, permits payment of prepetition unsecured claims in the early stage of Chapter 11 when the failure to make those payments is detrimental the debtor's reorganization. Consequently, the Necessity Doctrine is consistent with the underlying policies and goals of Chapter 11 and reorganization of a

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CAN AN INVOLUNTARY PETITIONING CREDITOR THAT IS A CREDITORS' COMMITTEE MEMBER RECEIVE A MORE FAVORABLE FINANCIAL DEAL WITH DEBTOR THAN OTHER VENDORS?

Scott Blakeley

One of your long term customers has failed to pay your invoices resulting in a six figure delinquent account. You learn that the debtor's cash flow crunch has resulted in a failure to pay vendors generally. Is your next step to act individually and attempt to collect on your delinquent account? Or do you act collectively with other vendors to collect on your delinquent account? While a number factors are involved with this decision, often a credit professional determines acting collectively with other vendors may be the most expedient method to get paid where it is found that the debtor is generally not paying vendors.

Vendors collectively may find the commencement of an involuntary chapter 7 or chapter 11 bankruptcy petition (the Bankruptcy Code excludes chapters 9, 12 and 13 involuntary proceedings) to be one of the most effective tools they have against a debtor to collect on their delinquent open account in appropriate circumstances, as an involuntary bankruptcy may be viewed as the ultimate prejudgment attachment since it freezes the debtor's assets for the benefit of all creditors.

A company that is the target of an involuntary petition, of course, will consider many devices to defeat the vendors involuntary petition. One of the debtor's alternative to attempt to defeat an involuntary petition is pay off the debt of some or all of the petitioning vendors' delinquent accounts. But what is the consequence if the vendor joins in with the involuntary petition and the debtor offers to pay the vendor's delinquent account? Can the vendor accept the payment and bow out of the involuntary petition? What if the petitioning creditor later serves on the creditors' committee. Can a creditors' committee member receive a better financial deal than other unsecured creditors? A bankruptcy court recently ruled that a vendor could not defeat an involuntary petition by withdrawing after reaching its own financial deal with the debtor. Nor can a petitioning creditor that serves on the creditors' committee receive a more favorable deal than other unsecured creditors.

A Vendor Joins In An Involuntary Petition

A corporate debtor, a distributor of sporting goods, was unable to pay its debts to vendors. The debtor began liquidating its assets. Vendors got wind that the debtor had transferred all of its inventory to a new entity located at the same location, at the debtor's former location with former employees. Seven vendors filed an involuntary Chapter 7 bankruptcy petition against the debtor. The debtor converted the case to a Chapter 11 reorganization. The petitioning creditors were appointed to the creditors' committee.

The Elements Of An Involuntary Bankruptcy Petition

Eligibility to File

An eligibility requirement to file an involuntary petition is that the petitioner be a creditor holding an unsecured claim aggre-

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FROM THE PUBLISHER:

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If you have a hot topic affecting the credit and financial professional, e-mail this to Scott.

FUTURE OF CREDIT: WHAT SPECIFICALLY MUST I DO?

Gordon Lundene
Kenwood USA

The futurists' message is: "Your world is about to get turned upside down; and you better embrace change, or you'll be left out in the cold." Alas, the problem usually remains an abstraction, or the authors' examples do not address the credit function.

What do they mean by "embrace change"? Hug a Tom Peters' book? Some take a New Age approach. They mumble fashionable cliches, think good thoughts, and hope that gets them through the day; though they say nothing of substance, and demonstrate no understanding of what they said. It is like living in a Dilbert cartoon.

Opposition to change can appear more coherent and sympathetic since change creates specific 'victims' who must adapt or be left behind. An example of this was evident at a presentation by a credit manager who was able to reduce staff from 14 to 3 by transferring tasks to an extranet for customers to get invoice copies, PODs, account balances, etc., instead of calling Credit. A hostile question from the audience questioned whether the Human Cost of this change was considered.

This criticism is both irrelevant and wrong.

Irrelevant because activist shareholders will not tolerate management that makes their company non-competitive. If present management won't do it, the new one will.

Wrong because giving an employee with antiquated skills a false sense of security betrays their trust in their employer, and jeopardizes their future income when the skill-gap between what they have to offer, and the labor market demands is greatest. The human cost is greater in ignoring change, or inappropriate preparation.

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THE ANTRITRUST LAWS, B2B AND THE ELECTRONIC CREDIT DEPARTMENT: CONCERNS FOR THE CREDIT PROFESSIONAL?

Scott Blakeley

The Internet is revolutionizing how the vendor brings its goods to market, and how the credit professional handles credit transactions. In the commercial setting, vendors are finding their customers joining together to form B2B sites with the intention of acquiring goods at the lowest price. While B2B sites may take different forms depending on their location in the supply chain, a B2B site generally provides that customers list goods they seek from vendors who then electronically bid for the contract. Periodicals announce seemingly daily of industries proposing B2B sites.

Notwithstanding the announcements from various industries, B2B has been slow to be adopted, principally because of antitrust concerns that, for example, vendors may join with competitors to engage in price collusion to keep prices high. Alternatively, the FTC is concerned that B2B owners may pressure vendors to lower prices by the owners sharing price information with one another. However, the Federal Trade Commission recently approved a B2B website created by automakers Ford Motor, General Motors and DaimlerChrysler, to buy parts from vendors on a single website.

What does B2B mean to the credit professional? While setting price is traditionally a function outside of a credit professional's responsibility, establishing credit terms impacts pricing and has been recognized by the United States Supreme Court as pertinent to the antitrust laws. Are the traditional concerns of sharing credit information amongst credit professionals and industry groups now subject to added scrutiny by the Justice Department and the Federal Trade Commission in light of B2B?

Legislation And Regulation Catching Up With The Internet

E-commerce and the Internet are evolving seemingly daily. Congress and federal and state regulatory agencies are attempting to keep current with technological developments by enacting new legislation and applying some century old legislation to today's technology. For example, on June 30, 2000, President Clinton signed into law the The Electronic Signatures in Global and National Commerce Act (E-Signature Act). The E-Signature Act makes e-signatures as legally binding as ink-and-paper signatures in all states. The E-Signature Act also eliminates legal barriers to storing documents and sending notices electronically. Legislation is catching-up with the electronic credit department. But are the century-old antitrust laws applicable to the Internet and the evolving electronic credit department?

What Is B2B?

B2B is commonly referred as electronic or web site exchanges where competitors band together to create an electronic marketplace to buy and sell and goods. These web sites hope to wring more profit from suppliers and drastically reduce dependence on middlemen. Companies from mining to tires to automotive to aerospace to steel trading and chemical have stated their intention to open B2B sites.

The Antitrust Laws From The Trade Creditor's View

The United States has two federal antitrust laws that may impact a credit professional: The Sherman Act and the Robinson-Patman Act. The primary objective of the antitrust laws is to eliminate practices that interfere with free competition in the marketplace.

To violate the Robinson-Patman Act, the seller must discriminate in price between the products being sold. The term "price" is generally the amount actually paid for the goods by the buyer. The U.S. Supreme Court has held that credit terms are an inseparable part of price, and that the extension of credit is equivalent to giving a price discount.

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RECEIVED A BAD CHECK FOR YOUR COMMERCIAL SALE? A VENDOR'S RIGHTS UNDER THE BAD CHECK LAWS

Scott Blakeley

Your credit analysis concludes that a new corporate customer may be too much a credit risk and you insist on a COD sale. You authorize shipment with your delivery driver to pick up a corporate check from your customer with delivery of the goods. The goods are delivered, but when the corporate check from your customer is presented it is returned "NSF". Your customer files bankruptcy.

What is the vendor's rights against the corporation for the bounced check? Does the vendor have rights against the corporation's controller that signed the check, which had been expressly authorized by the company's president and sole shareholder? Is there criminal liability?

Overview Of Bad Check Laws

Bad check law is governed by state law, not federal legislation. All states have bad check laws. Each state may have different statutory provisions as to whether a party may be guilty of a crime and may be subject to civil penalties. Bad check law combats the principle of deception: the buyer of goods or services deceives the vendor into believing that payment is made, and the vendor releases the goods in reliance on such representation.

Generally, a vendor is required to establish the buyer's intent to defraud and knowledge of insufficient funds for a valid claim under the bad check laws. Most states provide that it is prima facie evidence of insufficient funds if: (a) the check was not honored, and (b) the buyer did not pay the check after written notice of dishonor of the check. Under the bad check laws, a vendor may have claims against the buyer on a civil basis (collection of the debt) and a criminal basis.

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FEDERAL COURT RULES THAT EQUAL CREDIT OPPORTUNITY ACT GOVERNS BUSINESS CREDIT (Continued)

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making and notifications?

A. The Federal Court Ruling That ECOA Governs Business Credit

In the federal District Court opinion, the credit applicant, a business to be owned by an African-American, was denied business financing and credit. The applicant sued alleging violations under ECOA. The court rejected the companies' argument that ECOA does not apply to a business transaction:

"By is plain terms, the statute applies to 'any credit transaction.' The Regulations are clear that [ECOA] applies to all credit-—commercial as well as personal. A list of exceptions does not provide any general exclusion for commercial credit transactions."

1. Applying ECOA To Business Credit Transactions

How can a federal court conclude that legislation intended to govern consumer credit apply to commercial credit transactions? Look to the statute. The language of ECOA is broad, stating that a 'creditor' shall not 'discriminate against' an 'applicant' regarding any aspect of a 'credit transaction.' The United States Supreme Court has held that in interpreting a federal statute, courts are to give effect to a statute's plain meaning.

Furthermore, the current regulations promulgated by the Board of Governors of the Federal Reserve System are also expansive. Under the regulations, ECOA applies to 'credit transactions' which are defined as 'every aspect of an applicant's dealings with a creditor regarding an application for credit or an existing extension of credit (including . . . information requirements; investigation procedures; standards of creditworthiness; terms of credit; furnishing of credit information; revocation, alteration, or termination of credit; and collection procedures"). Given the broad definition of 'credit transaction", the court could reasonably conclude the ECOA governs business credit as well as consumer credit.

B. What Is ECOA?

ECOA was enacted by Congress in 1989, and the Federal Reserve Board issued Regulation B to implement ECOA in 1990. ECOA is a federal statute that prohibits credit grantors from discriminating in the granting of credit based on a prohibited basis, including race, color, religion, national origin, gender, marital status or age (collectively referred to under the regulations governing ECOA as the 'Prohibited Basis'). As ECOA is a federal statute, it applies to all states. ECOA is intended to promote the availability of credit without regard to characteristics that have nothing to do with creditworthiness. Creditors are required to notify applicants of action taken on their applications, and to retain records of credit applications.

ECOA's prohibitions against discrimination are aimed primarily at the evaluation of a credit application by a credit grantor. The general rule is that a credit grantor can consider any information it obtains in evaluating whether to extend credit so long as the information is not used to discriminate against an applicant on a prohibited basis.

1. Only Applies When 'Credit' Is Considered To Be Extended

ECOA only applies when "credit" is considered to be extended. "Credit" is defined as "the right granted by a creditor to a debtor to defer payment of a debt or to incur debts and defer its payment or to purchase property or services and defer payment therefore." Thus, a vendor extending business credit on, for example, 30 day terms, can be reasonably read as an extension of "credit" under ECOA.

C. Notice Of Credit Decision And Statement Of Reasons: The 30/60/30 Day Rules

ECOA requires credit grantors provide written notification to applicants.

1. Notice of Adverse Action Within 30 Days

Under ECOA, a credit grantor must provide notice to the applicant of action taken with the request for credit within 30 days after a completed application is received by the credit grantor. The possible actions under ECOA is (a) an adverse decision ('Adverse Action'), (b) a counter-offer, or (c) granting the credit requested. Adverse Action is defined as:

a. Refusal to grant credit in substantially the amount or terms requested??unless the credit grantor makes a counteroffer (for different credit terms) and the applicant accepts the counteroffer;

b. Termination of an account or an unfavorable change in terms; or

c. Refusal to increase the amount of credit available.

If Adverse Action is taken, notice must be provided by the credit grantor to the applicant that the party has the right to request reasons for the Adverse Action in writing within 60 days of such action. *See* Attachment A. Notification may be done verbally if the application was verbally made, otherwise it must be done in writing. ECOA provides that the notice of Adverse Action must contain language advising of ECOA similar to that in Attachment A.

2. Credit Applicant's Request For Statement Of Reasons Within 60 Days

The applicant has 60 days from receipt of the credit grantor's Adverse Action letter to request an explanation of adverse ruling.

3. Credit Grantor's Statement Of Reasons Within 30 Days

If an applicant requests an explanation of Adverse Action within 60 days, the credit grantor is to provide a statement of reasons within 30 days. The credit executive is not required to provide specific reasons for the Adverse Action, but instead may provide language such as, "adverse credit history"; "lack of business experience"; "lack of working capital"; or "too much secured

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FEDERAL COURT RULES THAT EQUAL CREDIT OPPORTUNITY ACT GOVERNS BUSINESS CREDIT (Continued)

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debt." One form of letter addressing the statement of reasons letter is provided as Attachment C.

D. Obtaining A Spouse's Personal Guarantee

ECOA does not permit a credit grantor to require a spouse to sign a personal guaranty if that spouse is not directly involved with the applicant. A personal guarantee can be required only when an applicant does not meet the creditor grantor's scoring model for credit. If the business owner's spouse is not involved in the business and does not hold a position with the corporation, a personal guarantee that includes the spouse may be discriminatory.

E. Retention Of Records

ECOA requires credit grantors to retain records for applicants denied credit. The records a credit grantor retains are the credit application, the credit grantor's notification of action, the statement of specific reasons for the adverse action and the applicant's written statement alleging violation of ECOA.

The period of time that the records must be retained depends on the amount of the gross revenues of the applicant. For credit applicants with gross revenues of $1 million or less, the credit professional must keep records for 12 months after notification. For credit applicants with gross revenues in excess of $1 million, the credit professional must keep records for at least 60 days after notification. However, if an applicant requests that the records be retained, the creditor must retain the records for 12 months.

Retention of records is required beyond 12 months if the credit grantor has notice that it is under investigation, is subject to an enforcement proceeding, or is served with notice of an action filed. Then records must be kept until the later of the 12 months or the final disposition of the matter, unless an earlier time is allowed by court order.

The statute of limitations to commence an action against the credit grantor is two years after applying for credit.

F. ECOA In The Internet Age

The Internet is revolutionizing how the credit professional handles credit transactions. Credit professionals are using the Internet for a myriad of credit and financial functions, from credit research and scoring, to automatic invoicing customers through their Web site, to automatic payment posting. Credit departments are loading their web pages with credit applications and guarantees for the customer to retrieve. The electronic credit department has arrived.

On June 30, 2000, President Clinton signed into law the The Electronic Signatures in Global and National Commerce Act (The E-Sign Act). The E-Sign Act makes e-signatures as legally binding as ink-and-paper signatures. The E-Sign Act also eliminates legal barriers to storing documents and sending notices electronically. A credit professional may now engage in e-credit transactions across state lines and the credit sale contract is valid in all states.

Neither the E-Sign Act nor the ECOA should bar a credit professional from electronically notifying an applicant of Adverse Action or storing credit information electronically, and otherwise be in full compliance with the FCRA. However, the E-Sign Act requires that the consumer decides whether to use an e-signature or handwritten signature, and the vendor must conduct test e-mailings before sending out subsequent e-mail notifications.

1. E-Notification Of Adverse Action And Statement Of Reasons

ECOA requires a credit grantor give notification of Adverse Action. The E-Sign Act may allow a credit grantor to give electronic notification of Adverse Action and statement of reasons.

2. Storing Credit Applications Electronically

The E-Sign Act authorizes storing documents electronically. This means that a credit professional may store electronically the credit files of declined applicants.

G. Avoiding The ECOA Lawsuit: Steps To Comply

A paper trail demonstrating to disgruntled applicants (or their counsel) or FTC audits that a credit grantor complies with ECOA can be useful in keeping lawsuits at bay. To comply with ECOA, there are several steps a credit grantor may consider adopting. These steps assist the credit grantor in creating a paper trail evidencing compliance with ECOA.

1. **Company Policy:** consider adopting a stated policy that there shall be no discrimination on a prohibited basis with the extension of credit.

2. **Written Manual:** consider including in your company's policy manual a statement the company complies with ECOA.

3. **Training The Troops:** Train credit and sales personnel about ECOA. ECOA may also apply to the credit grantor's sales' brokers and agents if the company cloaks them with authority to request credit information from the applicant.

4. **Credit Application**: The credit application should provide for statement of the vendor's compliance with ECOA. *See* Attachment A. The credit application should not include any language or seek information that may lead an applicant to believe that the information sought would be used to discriminate. *See* Attachment A.

5. **Personal Guarantee:** ECOA does not permit a credit grantor to require a spouse to sign a personal guaranty if that spouse is not directly involved with the applicant.

6. **Notification To Applicant:** Comply with the 30/60/30 written notification.

7. **Record Keeping:** Store credit records. Digital records may be recognized.

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ARE YOU A CRITICAL TRADE VENDOR THAT MERITS IMMEDIATE PAYMENT ON YOUR PREPETITION CLAIM IN CHAPTER 11?: AN UPDATE ON THE NECESSITY DOCTRINE (Continued)

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financially struggling enterprise. Creditors, usually grudglingly, realize that it is in their best interests to permit certain vendors holding prepetition claims to be paid immediately, because failure to pay "critical" vendors will result in detrimental consequences to all.

The most common basis for the use of the Necessity Doctrine is by utilization of common law. Although courts have authorized payment of numerous kinds of prepetition debts, each use of the Necessity Doctrine is fact-specific. The most common use is to pay benefits related to employment. However, courts are becoming more receptive to authorizing payments to critical vendors. The United States Supreme Court first articulated the necessity of payment doctrine over a century ago.

The Necessity Doctrine has its genesis in the common law Necessity of Payment Rule and the Six Month Rule. The principle of both doctrines is that the immediate payment to a prepetition creditor will assist all creditors because the reorganization plan is better situated for success.[1] Both principles are premised on the bankruptcy goal of maintaining the prospects for a viable reorganization. Additionally, these doctrines recognize that some prepetition creditors should be paid immediately to effectuate a successful reorganization.

Another authority for the Necessity Doctrine is found in the Code. Although the Bankruptcy Code does not expressly authorize the payment of prepetition unsecured claims, section 105 of the Code is often cited to empower the Court to authorize necessity payments. Section 105(a) provides that the court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

There are two prevailing views regarding the use of section 105. First, some courts favor the broad view and allow payment of prepetition debts with postpetition funds. These courts often justify that the Code enables a court to do whatever is necessary to aid in its jurisdiction over the bankruptcy case. Accordingly, a court may authorize the payment of prepetition debts in order to preserve the potential for an effective reorganization. As a consequence, prepetition debts of the same class are treated differently in reorganization cases because the unique position of the vendor. Alternatively, some courts believe "equity" powers should be used sparingly, if at all. Courts that reject Necessity Doctrine conclude that such payments violate the Code's inflexible priority scheme and fail to treat similarly situated creditors alike. If Delaware is any indication of which of these two viewpoints is favored in bankruptcy, the trend appears to favor a broad view of the Necessity Doctrine.

The Owens Corning Example

The recent Chapter 11 filing of Owens Corning, provides an illustration of a bankruptcy court's willingness to authorize payments pursuant to the Necessity Doctrine. On October 5, 2000, Owens Corning ("Debtors") filed a voluntary petition for reorganization under Chapter 11 along with its First Day Orders. Debtors are world leaders and specialize in the manufacture and sales of insulation, roofing systems, exterior systems for the home and glass fiber materials used in composites. The net sales of its products in 1998 and 1999 were approximately $5 billion per year. The bankruptcy petition was filed in response to pending asbestos claims.

In its First Day Orders, Debtors requested that the court authorize payments of prepetition debts to three classes of creditors. These classes include: (1) Critical Material Vendors," which provide critical materials in substantial qualities with aggregate claims of approximately $48 million; (2) "Critical Project Vendors," which are involved in major capital improvement projects with aggregate claims of approximately $19 million; and (3) "Critical Affiliated Vendors," which are subsidiaries and affiliates in foreign countries with aggregate claims of approximately $23 million. Debtors claim that these three classes provide services that are intricately intertwined to Debtors' business and that failure to honor the prepetition debts would severely damage the business, perhaps beyond repair. In exchange for payment on prepetition debts, vendors would be required Debtors with normal trade relations and credit throughout the bankruptcy proceedings.

The court granted Debtors' request to pay prepetition debts to the vendors. The court initiated a procedure to assure normalized trade relations would continue after payment. If any vendor accepts the prepetition payment and fails to provide services, then the payment can be recovered as a preference. The vendors' claim will then be reinstated as if the payment were never made and recovery would be delayed.

Factors to Consider

Owens Corning is simply one example of the effective use of the Necessity Doctrine for the immediate payment of a vendor's prepetition claim. The court considers several factors when authorizing payment pursuant to the Necessity Doctrine. The most common rationale is that the product or service offered by the vendor is unique and cannot be easily replace. Second, it is common for courts to apply the Necessity Doctrine after finding that payment advances the best interests of the debtor and creditors. For example, the courts usually authorize payment if the relief requested is essential to the continued operation of the Debtor's business. Factors that the courts do not usually consider include, the size of the case, nature of the business, and the amount of the pre-petition claim. Accordingly, authorization for necessity payments is simply a means to the effective reorganization of the debtor.

It is crucial for the debtor to obtain court authorization for all necessity payments. The failure to obtain authorization may result in an action against the vendor to recover the payment as an unauthorized postpetition transfer. In these instances, the bankruptcy court may avoid the payments. If this occurs, the prepetition vendor is directed to return the funds to the trustee or debtor in possession.

Conclusion

The Necessity Doctrine can be an extraor-

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ARE YOU A CRITICAL TRADE VENDOR THAT MERITS IMMEDIATE PAYMENT ON YOUR PREPETITION CLAIM IN CHAPTER 11?: AN UPDATE ON THE NECESSITY DOCTRINE (Continued)

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dinary remedy for a vendor. It should be noted that a vendor is usually required to provide postpetition credit in exchange for the early payment of the prepetition claim. In today's world of Owens Corning, and similarly situated debtors, the Necessity Doctrine has a newfound meaning in assisting the effective reorganization of a financially struggling enterprise.

[1] The necessity of payment doctrine "...permits immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre- reorganization claims shall have been paid." The Six Months Rule permits claims for services and goods supplied to a railroad six months before filing to be paid as administrative expense priority claims.

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THE ANTRITRUST LAWS, B2B AND THE ELECTRONIC CREDIT DEPARTMENT: CONCERNS FOR THE CREDIT PROFESSIONAL? (Continued)

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The antitrust laws generally prohibit the exchange of price information out of concern it may lead to price fixing. However, courts have allowed the exchange of credit information through industry credit groups. However, key to sharing of credit information is that each industry group member makes credit decisions independent from competitors.

Price Fixing And B2B

Given the traditional definition of the antitrust laws, how do the antitrust laws apply to B2B and affect the credit professional? B2B sites owned by corporate manufacturing rivals create opportunities for collusion and price-fixing that did not exist before. On B2B sites, vendors offer their products, prices and credit terms jointly, and buyers combine their orders jointly. B2B sites give vendors the opportunity to signal each other about price increases or credit term changes, or buyers a chance to conspire to pay artificially low prices for their goods. The reason is that B2B sites give vendors the opportunity to see current price and credit information immediately, which makes it easier to coordinate pricing and credit terms.

Vendors bidding their products on B2B sites should resist sharing price and credit information with competitors, as it may be viewed as price collusion. The Justice Department and the FTC are scrutinizing B2B exchanges to make sure that such exchanges foster competition rather than dampen it.

Antitrust And The Credit Professional In The Internet Age

The Internet is changing the way commercial credit is granted and goods are brought to market. The FTC's recent approval of the automakers B2B website may signal that the FTC and the Justice Department will promote an antitrust policy to allow collaboration between competitors. For the credit professional, the antitrust laws still have force in their day-to-day credit decision making if done electronically. Perhaps the easiest remedy for a credit professional to avoid the appearance of price collusion and price fixing with B2B sales is that firewalls are created so that information will remain confidential between competitors.

CAN AN INVOLUNTARY PETITIONING CREDITOR THAT IS A CREDITORS' COMMITTEE MEMBER RECEIVE A MORE FAVORABLE FINANCIAL DEAL WITH DEBTOR THAN OTHER VENDORS? (Continued)

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gating $10,000. If a debtor has greater than 12 creditors, then three petitioning creditors' claims must aggregate $10,000. Secured creditors may waive their security to be eligible, or else have an unsecured portion of their claim that aggregates $10,000.

Claims Subject To A Bona Fide Dispute

A petitioning creditor must hold a claim that is not subject to a bona fide dispute. The Bankruptcy Code does not define "bona fide dispute," but the established standard disqualifies a creditor whenever there is a legitimate basis for the debtor not paying the debt. The reasoning behind excluding claims subject to a bona fide dispute is to prevent creditors from using involuntary bankruptcy as a club to coerce the debtor into paying debts for which the debtor, in good faith, believes it has legitimate defenses. To disqualify a petitioning creditor on the grounds that the claim is subject to a bona fide dispute, a dispute must exist as to the validity of the entire claim and not merely a portion of the claim.

The Debtor Generally Not Paying Its Non-Disputed Debts As They Come Due

The petitioning creditor or creditors must assert that the debtor is generally not paying its debts as they come due. The Bankruptcy Code does not define the "generally not paying" test. The standard is not to be applied mechanically; it is not a matter of simple mathematics of paid debts to unpaid liabilities. Rather, courts employ factors, the most common of which are: (1) timeliness of payments of past-due obligations; (2) amount of debts long overdue; (3) length of time during which the debtor has been unable to meet large debts; (4) reduction in the debtor's assets; (5) the amount of the debtor's debt compared to the amount of the debtor's yearly income; (6) the debtor's liquidity; and (7) whether insiders deferred payment on account of sums payable to them.

To determine whether a debtor is generally not paying its debts involves consideration of the totality of the circumstances, balancing the interests of the debtor and creditors. The fact that a debtor is not paying the petitioning creditors may not be sufficient to prove an involuntary petition in itself. Where claims of petitioning creditors represent a substantial percentage of the debtor's outstanding indebtedness, courts have found that the creditors satisfied the standard for generally not paying debts. "Generally not paying" has been described by one court to mean that the debtor is regularly missing a significant number of payments which are significant in amount in relation to the size of the debtor's operations.

The alternative standard for commencing an involuntary bankruptcy petition is the transfer of substantially all assets by a debtor to a third party for an out-of-court liquidation. The creditors must file the involuntary petition within 120 days of the transfer.

Proposal To Pay Petitioning Creditors' And Committee Members' Claims

The petitioning creditors, through the creditors' committee, filed a motion to appoint a Chapter 11 trustee. The debtor's insider offered to purchase the petitioning creditors' claims, in exchange the motion for the appointment of a trustee would be withdrawn. The agreement between the debtor's insider and petitioning creditors was presented to the bankruptcy court for approval. The debtor's insider proposed to purchase the petitioning creditors' claims at 70%. Other unsecured creditors would receive not more than 40% through the liquidation of the debtor's assets.

The Office of the United States Trustee, an adjunct of the Justice Department, and some unsecured creditors objected to the settlement, contending that the petitioning creditors were breaching their fiduciary duties by agreeing to the settlement. The petitioning creditors were allegedly breaching their fiduciary duties as they were members of the official creditors' committee. The purpose of the creditors' committee is to maximize payment to unsecured creditors.

The bankruptcy court observed of the settlement:

> "it could appear to other creditors that the committee member either is using information available only to committee members or is using the status to further its own interests at the expense of those creditors. . . the committee members are to receive payment of 71% of their claims. In contrast . . . the debtor has proposed a much smaller dividend to be paid to other unsecured creditors as part of a pending chapter 11 plan."

The court found that the proposed settlement could result in a breach of the creditors' committee members breach of fiduciary duties. The court further observed:

> "By filing an involuntary petition, they may have constrained their own conduct as well as the debtor's. For example, it is generally understood that a creditor may not petition for involuntary relief and then defeat the involuntary petition by withdrawing after reaching its own repayment agreement with the debtor. Such settlements and withdrawls allow the involuntary process to be misused by one creditor for its own benefit. . . Similarly, the petitioning creditors' consent to serve on an official creditors' committee may have also served to limit their ability to act in their own self interest."

A Creditors' Committee Member's Fiduciary Duties

Members of the creditors' committee owe a duty of trust, responsibility and undivided loyalty to unsecured creditors. Consequently, whenever a creditors' committee votes on a issue, the individual members have a strict duty to vote with the overall interests of the unsecured creditors in mind. A committee member who violates fiduciary duties may be removed from committee, and possibly face personal liability.

Vendors Acting Collectively To Get Paid Still And Monitor Debtor Still Effective

The Bankruptcy Code provides that petitioning creditors may receive payment on their delinquents accounts by the alleged debtor that may be greater than similarly situated vendors, subject to notice to creditors and the bankruptcy court approval. However, as the court's decision reminds vendors, if a petitioning creditor elects to serve on a creditors' committee, once the company is ruled an eligible debtor, than the vendor has a fiduciary responsibility to creditors of that class and cannot receive a greater percentage payment on the claim.

FUTURE OF CREDIT: WHAT SPECIFICALLY MUST I DO? (Continued)

(continued from page 2)

Doing 100% of the job 100% of the time is no longer sufficient because it does not anticipate the future. Employees are not children, and must outgrow the paternalism of the past. We must think like a consultant. What will my present, or future employer need from me, and how do I gain the credit skills of tomorrow?

But what is it one must do to "gain the credit skills of tomorrow"? Which classes do I take, if any? What books do I read?

My partial answer involved preparing analysis reports from computer systems that do not have these built in. Aging data files are downloaded and combined with data from other systems to produce new reports management did not have before.

A mainframe computer system that only produced an aging by account number, surrendered its data to give agings by collector, sales rep, and largest past-due accounts with collection notes. Charts illustrated the data to visually compare performance over time, and parties involved. In an environment where dunning letters were an impossible dream, they became a reality.

The tools required include some knowledge of Microsoft Excel©, Microsoft Access©, Datawatch Monarch©. Since most of these programs are written in Visual Basic©, its knowledge would be useful in automating operations within Excel©, and Access©. Its study remains a personal development project for me.

What resources did I use? The Credit Research Foundation, NACM Credit Congress seminars, Access For Dummies and Access Bible from IDG Books, and assistance from co-workers helped work through problems and aided my education.

If a company installs an Enterprise Reporting Program (ERP), will this preparation itself become an antiquated skill? That remains an open question. Those with ERP programs say credit is an afterthought, and they all require bolt-on products to meet our needs. If management will not include these accessory programs, the skills certainly remain current. If management does purchase credit specific programs, then it could be useful in exploiting its full capabilities.

Is my experience the best or only solution Obviously, no. The jury is still out.

What is on my wish list for continuing education? Seminars showing others' solutions, and programs that make the most of less than optimal resources. Specifically, a seminar that enabled me to quickly, and easily produce a customer scorecard, like ones used to rate and rank vendors, is most welcome. Perhaps the American Society for Quality is listening?

Dun & Bradstreet's withdrawal from the seminar circuit eliminated a major distribution channel for enterprising credit people, and the active retired. The internet has yet to prove itself as a channel for education. Yet, the quest to stay ahead of the wave of change is permanent, and the responsibility of the individual credit professional.

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RECEIVED A BAD CHECK FOR YOUR COMMERCIAL SALE? A VENDOR'S RIGHTS UNDER THE BAD CHECK LAWS (Continued)

(continued from page 3)

A Vendor's Claims

When the check is dishonored, a vendor has a claim for breach of contract. The vendor may also have a claim for fraud and check deception. The supposed buyer of goods without the intent to pay may constitute fraud. The purported purchaser's silence on this fact may constitute fraud, if such information is not reasonably available to vendor.

A Vendor's Remedies

A vendor may sue for the amount of check that was dishonored, treble damages and up to $1,500 plus attorneys' fees and costs. A vendor should send a demand letter for payment to the buyer advising of treble damages and an opportunity to cure the bounced check within 30 days.

Customer's Defenses That Check Is Unenforceable

A buyer may have defenses to the bad check. One defense the buyer may assert is a good faith dispute defense. The basis for this defense is that the goods or services were not as promised. The rationale for the exception is that a vendor cannot coerce the buyer into paying a bill which is unjust or which the buyer, in good faith, disputes.

Another defense asserted by the buyer to the bad check is the representative capacity defense, i.e., the check maker was an agent or conduit. Other defenses to the bad check are that the contract is illegal and the buyer does not have the capacity to contract.

Bankruptcy Laws

If your customer that issues the bad check files for bankruptcy, what are your rights? One must look at the type of business enterprise that issued the check. If the check is issued by a sole proprietorship, as opposed to a corporation or LLC, the vendor may

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RECEIVED A BAD CHECK FOR YOUR COMMERCIAL SALE? A VENDOR'S RIGHTS UNDER THE BAD CHECK LAWS (Continued)

(continued from page 9)

have a nondischargeable claim that rides through the individual's bankruptcy. If the check is issued by a corporation the vendor must pierce the corporate veil to find the individual personally responsible. There are no nondichargeable claims against a corporation as the corporation is not entitled to a discharge in bankruptcy.

Under Bankruptcy Code section 523 certain claims may be excepted from an individual's bankruptcy. Where property is obtained by the debtor's false pretense, false representation or actual fraud such claim may be excepted from discharge. The legal issue is whether presentation of the check misleads the vendor into believing that the buyer intends to pay, thereby raising to the level of false pretense, false representation or actual fraud. There is a distinction by courts between express and implied misrepresentation.

A bankruptcy appellate court recently ruled that a vendor that had received a NSF check could not have this bad debt excepted from the debtor's bankruptcy discharge. The court ruled that a debtor merely presenting a check that later bounces does not make it a nondischargeable debt. Rather, the court stated, "the creditor must show that the debtor was guilty of misrepresentation with to defraud in direct connection with issuance of the check."

Criminal Laws

The majority of the states treat the crime of bad checks as a misdemeanor. In states that make a distinction regarding a felony or misdemeanor, the amount of the check usually determines if the crime is a misdemeanor or a felony. The vendor must establish that the customer had knowledge on the part of the offender of the lack of funds or credit. Generally, in those states that treat a bad check as a felony, punishment may be by imprisonment for up to one year.

Personal Liability of Signer of Check

Does an individual signing the check commit the individual to personal liability? The first question is whether the representative signed in a proper representative manner, where the representative named the corporation and signed in a representative capacity: "ABC Corp. by Francis Smith, Treas."

The Uniform Commercial Code is one statutory authority that deals with the liability of an individual's liability. The UCC provides that the authorized representative signing the check in a representative capacity is not personally liable.

A vendor may have a separate claim for fraud against against the signer. Under a fraud claim, the vendor must establish that the individual signed checks aware that they would not clear as there were insufficient funds on deposit in the corporate account to cover the checks.

A state court of appeals recently considered a vendor's fraud claim against a corporate bookkeeper for signing checks when there was insufficient funds. In that case, bookkeeper signed two checks for payment to a vendor that later bounced. The vendor sued the bookkeeper for fraud.
The court recognized that corporate signers of checks who sign checks when they know the corporate accounts contain insufficient funds may be liable:

> "One who, with knowledge that there are insufficient fund in the account upon which the check is given for the purpose of inducing the sale of further merchandise on credit and it is unnecessary that the defendant benefit from the fraud, or that the account on which the check is drawn be in the name of the defendant. In short, it is sufficient if the defendant, as an officer of the drawer corporation, draws a check, makes delivery, knowing the check is 'bad' or will be dishonored on presentation, delivers it for the purpose of inducing plaintiff to rely on the inherent representations."

The court noted that key for the vendor is whether the corporate signer intended to defraud the vendor. The court found there was no evidence to show that the bookkeeper knew there were insufficient funds in the account when she signed the checks. The court also noted that the vendor's reliance on the bookkeeper's signature was reasonable. The court noted that the bookkeeper was not an officer or director. The court also noted that the bookkeeper as a low-level ranking employee of the debtor was unaware the debtor's available credit.

Check Fraud

In addition to bad checks, there are perpetrators that employ a check fraud scheme to defraud vendors. The perpetrator's action plan usually provides for obtaining a vendor's checking account number. The perpetrator usually produces checks with the vendor's name, then contacts the vendor's bank and verifies funds on hand and uses fake ID to cash checks. What are some of the steps vendors can take to protect themselves against this type of check fraud?

A vendor should consider depositing payments in a Deposit Only account, and the bank can then electronically transfer funds. The vendor may set up a positive pay account. The bank will only clear those checks listed by vendor. Contact your vendors for payment by electronic funds transfer. This allows you to authorize the bank to wire funds from your account directly to your vendor's account.

Steps A Vendor Can Take To Reduce The Risk Of Taking A Bad Check

There are a number of steps a vendor can take to eliminate or reduce the risk of bad checks, yet still make the sale (keeping the salesperson content). A vendor can use a check guarantee service. The vendor can have the salesperson pick up the check from the buyer, present the check for payment, and if it clears, release the goods. If the check has been returned and the goods released, the vendor may demand payment. If the buyer claims it has insufficient cash to cure the bounced check, the vendor may insist on payment by credit card.

FEDERAL COURT RULES THAT EQUAL CREDIT OPPORTUNITY ACT GOVERNS BUSINESS CREDIT (Continued)

(continued from page 5)

H. Types Of Evidence Proving Credit Discrimination

What type of evidence may prove a violation of ECOA?

1. Overt Discrimination: When a credit grantor blatantly discriminates on a prohibited basis. Expressions of a discriminatory preference may constitute a violation of ECOA even if the credit grantor does not act on the preference.

2. Disparate Treatment: When a credit grantor treats applicants differently based on a prohibited basis, the discrimination may be overt or subtle and does not require evidence that differences in treatment were caused by prejudice or conscious intention to discriminate.

3. Disparate Impact: When a credit grantor applies a policy or practice uniformly to all applicants, but the policy or practice has a disproportionate effect on groups protected under ECOA. There is no violation of ECOA if the disparity created by the policy or practice is justified by business necessity and there is no less discriminatory alternative.

I. Enforcement Of ECOA

Enforcement of ECOA may be through private lawsuit or through administrative enforcement. A creditor failing to comply with ECOA may be subject to civil liability for actual and punitive damages in either individual or class action lawsuits. Punitive damages are capped at $10,000 in individual lawsuits; and capped at the lesser of $500,000 or 1% of the creditor's net worth in class action lawsuits. Winning plaintiffs may also recover from the defendant reasonable attorneys' fees and costs. The Federal Trade Commission regulates ECOA.

ATTACHMENTS “A” – “C”

LANGUAGE FOR CREDIT APPLICATION

The Equal Credit Opportunity Act (ECOA) prohibits credit grantors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status or age. The Federal Trade Commission administers compliance with ECOA.

ATTACHMENT “A”

NOTIFICATION OF ADVERSE ACTION

[*Date*]

[*Name of Business*
Address
City, State & Zip Code]

Thank you for applying to us for unsecured credit. We cannot extend credit at this time.

If you would like a statement of reasons why credit was denied, please contact [*credit executive*], within 60 days of the date of this letter, at the following address. We will provide a statement of reasons within 30 days after receiving your request.

[*Company Name and Address*]

The Equal Credit Opportunity Act (ECOA) prohibits a credit grantor from discriminating against a credit applicant on the basis of race, color, religion, national origin, sex, marital status or age. The Federal Trade Commission administers compliance with ECOA.

Very Truly Yours,

[*Credit Executive*]

ATTACHMENT “B”

STATEMENT OF REASONS

[*Date*]

[*Name of Business*
Address
City, State & Zip Code]

In response to your letter requesting a statement of reasons why your request for credit was denied, we find that your [*adverse credit history*] [*lack of business experience*] [*lack of working capital*] [*excessive secured debt*] prevents us from extending credit at this time. The Equal Credit Opportunity Act (ECOA) prohibits a credit grantor from discriminating against a credit applicant on the basis of race, color, religion, national origin, sex, marital status or age. The Federal Trade Commission administers compliance with ECOA.

Very Truly Yours,

[*Credit Executive*]

ATTACHMENT “C”