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

IS YOUR VENTURE CAPITALIST-FINANCED CUSTOMER ABLE TO PAY FOR THE CREDIT SALE? SHOW ME THE MONEY: THE CASH-BURN RATE IS MORE IMPORTANT THAN EVER

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Venture capitalist (VC) financed businesses, often referred to as dot-coms, have provided new avenues for manufacturers and distributors to bring the product to market and make sales. Identifying the potential transformation in the distribution chain to scores of industries, VC's poured $100 billion into startup dot-com companies last year. The hallmark of the VC investment in a dot-com is to invest at the dot-com's startup, perhaps put an additional round or two of financing, and cash out through an IPO or when the dot-com is sold.

VC's never expected profits immediately from their dot-com investments. However, the VC's are restless with the continued downturn with their dot-com investments. Many dot-coms have burned through operating cash reserves, face losses and fierce competition, and tightened investment requirements from venture capital firms, resulting in a failure to pay vendors.

For the vendor selling to the dot-com, the capital structure is not like a "bricks-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 dot-com because of its limited operating history and lack of tangible assets to secure the financing.

However, when a dot-com's funding disappears, the dot-com often desperately searches for a buyer of the business. The insolvent dot-com either shuts its door, finds a buyer or takes cash at any price. Vendors go unpaid. Tired of companies burning through cash, bondholders have recently sued to halt use of cash and liquidate assets to pay creditors.

What Assets?

The value of most dot-coms is intellectual

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You are brought in by management to assist with a problem delinquent open account. Your longtime customer, who is a source of significant business, has paid outside of invoice terms over the last several months. Credit purchases are critical for the debtor's cash flow. Management does not want to lose the customer, and agrees to continued open account sales. Your job is to ensure that the debtor pays close to invoice, yet continues to purchase product from your company. You negotiate each sale and vigilantly monitor shipments. You are successful. The debtor pays more promptly. However, the debtor is unable to compete and its business declines. The debtor files chapter 11 in hopes of rehabilitating its business, but the case is later converted to a chapter 7 liquidation. Two years later you receive a letter from the trustee demanding all payments received by the debtor 90 days before the bankruptcy filing. The trustee contends the payments were preferential.

A bankruptcy court recently considered

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PARTICIPATING OWNERS: ENFORCING A MECHANICS' LIEN FOR MATERIALS AGAINST A NON-CONTRACTING PARTY

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During the past several years, the construction industry has enjoyed an unprecedented level of success ranging from new homes to business developments, including leasehold improvements on real property. The industry's success in large part is built on the extension of credit from "materialmen," or suppliers of material goods. The industry depends on credit because construction contracts seldom provide advance payment to contractors, but instead rely on scheduled or quarterly payments. Accordingly, a contractor usually does not have the capital to finance the improvements without the availability of credit.

As with any credit extension, there is a risk of nonpayment. The mechanic's lien has become the mechanism to assist in minimizing that risk by providing security for the underlying debt in the land and structure subject to the improvements.

However, a mechanics' lien may be unenforceable against the property owner if the materials are supplied in connection with a contract enter into with the lessee to make improvements on the land. If the lessee defaults or files bankruptcy, then the material supplier may be without a remedy, while the property owner receives a benefit without cost.

Mechanics' Liens and Material Goods

The mechanic's lien is a statutory, or in some states, a constitutional remedy and creation of state law. Although each state has its own version and requirements to enforce mechanics' liens, these statutes share common attributes. A claim for a mechanics' lien is an action in property to recover for materials furnished, not a personal action in contract for repair or improvement (e.g., breach of contract or quantum meruit, respectively).

In some states, enforcement of mechanics' liens is accomplished by foreclosure proceedings. Mechanics' lien statutes only protect certain classes of professionals or tradesman that contract with the owner or leaseholder for improvement of the property. The supplier of materials should appreciate the differences posed by contracting with the property owner directly or through the leaseholder individually.

It is important to consult the specific state law to determine the treatment of materials. State law dictates whether materials will qualify to enforce a lien. Generally, materials qualify for a mechanic's lien if incorporated into an improvement and with accompanying knowledge of their intended use on a specific site. Alternatively, some states specifically designate certain materials for qualification. The state laws on whether non-incorporated materials (e.g., rental equipment, utilities, maintenance, etc.) vary from state to state.

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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.

STANDBY LETTER OF CREDIT PROCEEDS BELONG TO CREDITOR NOT BANKRUPTY ESTATE

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You receive an e-P.O. from a customer requesting a six-figure credit purchase. You analyze the customer's limited financial and operating information and determine the customer is too much risk for a credit sale. If you insist on a cash sale, however, the customer will buy from a competitor. You are looking for a way to reduce the credit risk, but make the sale – a credit enhancement, such as a standby letter of credit (L/C) which allows for ready conversion to cash should the customer fail to pay. The customer agrees to have its bank issue a standby L/C, and you sell on 30 days credit. 45 days later the customer has not paid.

You receive an e-mail that the customer has just filed Chapter 11. You go to the issuing bank with the L/C documentation. The documentation conforms, but the bank officer has also received notice that the customer has paid. Must the bank honor the L/C or does the automatic stay bar the bank from paying you? If the bank pays, may a bankruptcy trustee recapture the L/C proceeds from you? A bankruptcy court recently considered whether a trustee may recover from a creditor the proceeds from an L/C that was drawn down postpetition. The bankruptcy court dismissed the trustee's lawsuit.

Vendor Looking For Guaranteed Payment

The creditor obtained an irrevocable standby L/C to guarantee payment in the event the debtor failed to pay. The debtor failed to pay and an involuntary bankruptcy petition was filed against the debtor. The trustee sent a letter to the creditor advising that the L/C was property of the bankruptcy estate and a draw-down of the proceeds would violate the automatic stay. The creditor

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BE MINDFUL OF EQUAL CREDIT OPPORTUNITY ACT REGULATION WHEN TAKING SPOUSAL GUARANTEE

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Your credit application includes a form personal guarantee, that includes a spouse's guarantee. Given the downturn in the economy, you insist that the president and her husband of the corporation you are selling on credit sign the joint personal guarantee. You authorize the first-time credit sale to the corporation, but fails to pay. You make demand on the president and the spouse to honor the guarantee. They refuse and you sue on the guarantee. The spouse raises as a defense to pay on the guarantee that your company has violated the Equal Credit Opportunity Act (ECOA). The spouse claims that the corporation was independently creditworthy, and was not involved with the business.

You are looking for ways to make the sale, but reduce the credit risk and personal guarantees may achieve this. But how can ECOA affect your taking a personal guarantee? A state appellate court recently considered the interplay of ECOA and personal guarantees and is instructive for the credit professional.

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.

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.

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E-SIGNATURE ACT BENEFITS BUSINESS AND CONSUMERS FTC REPORTS, SO WHAT DOES IT MEAN TO THE CREDIT PROFESSIONAL?

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The Electronic Signatures in Global and National Commerce Act (The E-Sign Act) went into effect November 2000. The E-Sign Act makes an electronic signature (e-signature) as legally binding as ink-and-paper signatures, and can be used in legal proceedings. An e-signature is generally defined as a form of technology, including fingerprint readers, stylus pads and encrypted 'smart cards', used to verify a party's identity so as to certify contracts that are agreed to over the Internet.

The Federal Trade Commission is the federal agency responsible for regulating the E-Sign Act. At the direction of Congress, the FTC has issued a report finding that the E-Sign Act is working for both business and consumers, after receiving input from 32 interested groups, ranging from computer companies and financial institutions to consumer groups and academics. The FTC recommends that no action should be taken by Congress to amend the E-Sign Act.

Given that the E-Sign Act is here and there are no plans to amend the law, what does it mean to the credit professional and the electronic credit department? Does documenting your electronic credit sale allow an e-signature to have the same legal effect as a handwritten signature from your customer on your credit application or P.O.? What is the legal status of e-signatures documenting your personal and corporate guarantees over the Internet? Do credit files stored electronically by have the same legal force as paper credit files in the event of a dispute with you customer? Has legislation caught-up with Internet technology?

The E-Signature Law

The effect of the E-Sign Act is a uniform and nationwide legal recognition that a vendor may engage in e-credit transactions across state lines and the e-contract is valid with all states.

Some of the relevant provisions of The E-Sign Act for the credit professional are: (1) Parties to the contract decide on the form of digital signature technology to validate the contract; (2) Businesses may use e-signatures on checks; (3) Businesses must require parties to the contract to make at least two clicks of a computer must to complete a deal; (4) The consumer decides whether to use an e-signature or handwritten signature; (5) Records of e-contracts may be stored electronically.

Verifying the E-Signature

A key question for the credit professional considering using e-signatures on contracts and checks, however, is having a reliable way to certify an e-contract, or authenticate an e-signature, to reduce the risk of fraud, or claims of unauthorized use of an e-signature. Technology to verify a person's identity, so-called digital identification devices, is solving these concerns.

The E-Sign Act And The Electronic Credit Department

The credit department is going "electronic" for a variety of reasons, including faster payments, reducing discrepancies with the customer, lower administrative costs, and the competition and customer requires.

An increasing number of credit departments are posting on their web pages various credit forms, including credit applications, guarantees, invoices and proofs of delivery, for retrieval by their customers.

How may the E-Sign Act affect the credit professional? Article 2 of the Uniform Commercial Code provides that with the sale of goods over $500, there must be a signed writing. A signature is to certify the writing for the sale of goods. With the traditional sale of goods over $500, the credit professional memorializes the sale agreement with a signed credit application and signed invoices.

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A SECOND POCKET WHEN YOU'VE RECEIVED THE CORPORATE "NSF" CHECK: PERSONAL LIABILITY WITH A CORPORATE CHECK?

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You conclude that a new corporate customer is too much credit risk and you insist on COD. You authorize shipment with your delivery driver to pick up a corporate check from your customer. The goods are delivered, but the corporate check is returned "NSF". May you recover the value of the check from the signer, the corporation's controller?

Overview Of Bad Check Laws

Bad check law is governed by state law and all states have such laws. Bad check law combats fraud: the buyer of goods or services deceives the vendor into believing that payment is made, and the vendor releases the goods in reliance on this.

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. But what of personal liability with corporate checks?

Personal Liability Of Signer Of Check

Does an individual signing a corporation's check commit the individual to personal liability, should the check be returned NSF?

Article 3 of the Uniform Commercial Code deals with checks. Revised Article 3 provides that a party with authority to sign a corporate check no longer has to indicate his or her representative capacity on the check. Revised Article 3 recognizes that the party signing the check in a representative capacity, such as a controller for the company, is not personally liable for the NSF check.

However, a vendor may have a separate claim for fraud against against the signer, depending on the jurisdiction. Under a fraud claim, the vendor must establish that the individual signed the corporate 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.

However, some jurisdictions have not adopted Revised Article 3. In those jurisdictions, a corporate employee who signs a corporate check bearing the pre-printed name of the corporation in payment of a corporate obligation still runs that risk. To avoid the risk, the signer must take two steps: name the corporation and indicate that the signing is made in a representative capacity.

The court of appeals for New York recently found that a signer of a corporate check personally liable when the check was returned NSF. The checks, which were preprinted with the corporate debtor's name, were signed by the controller without indicating that he was signing in a representative capacity, i.e., controller for the company. An exception is where the party may establish "an agreement, understanding or course of dealing to the contrary". The signer could not prove the exception.

Conclusion

A vendor that has received an NSF check from a corporate customer should consider whether the signer of the check may be a second pocket for payment. In certain jurisdictions, the vendor that has received the NSF check from the corporate customer may have a claim against the signer of the check.

1. Korhumel Steel Corporation v. Wandler, 229 Wis.2d 395, 600 N.W. 2d 592 (1999).

2. Thunderball Marketing , Inc. v. Riemer, 273 A.D.2d 29 (2000).

IS YOUR VENTURE CAPITALIST-FINANCED CUSTOMER ABLE TO PAY FOR THE CREDIT SALE? SHOW ME THE MONEY: THE CASH-BURN RATE IS MORE IMPORTANT THAN EVER (Continued)

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property, such as customer lists, licensed technology and engineering teams. In analyzing whether to sell the dot-com on credit, the credit professional must use different credit criteria. Excess cash burn rate is often the benchmark to determine whether the dot-com has assets available to pay for the credit sale. However, given the shakeout of dot-coms, a credit professional can no longer look to the VC to provide an additional round of financing to pay the vendor. Indeed, VC's view the current dot-com investment market as a "down round". This year VC's are expected to invest half what was invested last year. This means it is harder than ever for dot-coms to obtain additional financing, and perhaps harder to pay the vendor.

With the source of future capital stalled, more dot-coms are running out of cash and faced with either shutting their doors, finding a buyer, or securing cash from a VC at an extraordinary price. What does this mean to the credit professional?

No Assets Available For Vendors With Liquidating Dot-Com

A number of initially well-funded dot-coms have closed their doors, and auditors for several well-known dot-coms have issued warnings that the dot-com's survival is in "substantial doubt." Liquidation is a growth industry for the dot-com, and a dot-com's liquidation yields little for vendors. Indeed, a dot-com's market value bears little in a liquidation. E-Toys had a market value of $10 billion and its tangible assets have yielded cents on the dollar in the Chapter 11 liquidation. Creditors are owed over $285 million. Pets.com had a market value of $300 million. In an out-of-court liquidation, Pets.com assets yielded $6 million. Northpoint Communications had a market value of $5.6 billion, and was sold for $135 million. Webvan is a recent dot-com failure. With over $1 billion invested in venture capital money, Webvan recently filed Chapter 11 to liquidate its assets. Prior to its bankruptcy filing, Rhythms, an Internet provider, was spending $1.9 million a day greater than its revenue.

While a bricks-and-mortar company may have tangible assets that will allow it to reorganize should it run into financial difficulty, dot-coms do not fare well. The dot-com that cannot obtain an additional round of financing simply disappears. While a bricks-and-mortar company may find a buyer for its assets, a dot-com usually does not have such an opportunity. Dot-com assets are liquidated at 30% of invoice in best-case.

Show Me The Money: Analyzing Cash-Burn Rate

A dot-com 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 with a credit sale. With a publicly traded dot-com, the stock market may be a method for measuring its financial strength and ability to repay a credit sale. Given the VC's reluctance to provide additional financing to a dot-com, the credit professional must analyze the excess cash burn rate more closely than ever. The cash burn rate is determined by the amount by which a dot-com's expenses exceed its cash flow. Start-up dot-com's usually raise a year's worth of cash to operate at a time. The adage "cash is king" seems especially true for dot-coms, 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 dot-com's burn rate by the amount of cash it has. If the dot-com is publicly traded, the credit professional may look to the quarterly burn rate. A high burn rate will result in the dot-com unable to finance operations and repay vendors.

How does the credit professional obtain the financial information for a burn-rate analysis?

Cathy Markowitz is the Director of Credit for Newport Corporation, a global supplier of high precision components, instruments, micropositioning and measurement products and systems to the fiber -optic communications, computer periphereals, semiconductor equipment and scientific research markets.

Recently Newport began finding customer startup companies strapped for cash, and forced to wait months for a second round of VC funding. Newport found VC funding dramatically changed in a year. In addition to funding delays, customers are receiving much less VC funding than projected and the funding is being dispersed incrementally based on milestone accomplishments. In response to these factors and to prevent losses, Newport has made modifications to its customer startup VC matrix:

LEVEL 1 (Up to $250,000)

a) Confirmation of VC investment directly with the investor

b) Bank reference where VC funding is maintained

LEVEL 2 (Over $250,000)

a) Same as above

b) Same as above

c) 35 to 50% deposit and a security agreement

Both versions of this matrix were reviewed by sales and finance before implementation to ensure a fit with customers and to minimize risk. Some customers are reluctant to sign a security agreement or perhaps their VC's prefer that they don't, so Newport is creative with its credit options. Newport encourages startups to consider leasing, or letters of credit, if the startup VC matrix does not suit their situation.

With the economic downturn, there is no guarantee that dot-com startups will survive, so Cathy also does a lot of reading and attending seminars and venture capital forums to continually educate herself. This is a growing market segment for Newport, so there is a need to stay informed on credit and collections techniques as they change. Cathy also relies on the credit network developed through years as a credit profes-

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E-SIGNATURE ACT BENEFITS BUSINESS AND CONSUMERS FTC REPORTS, SO WHAT DOES IT MEAN TO THE CREDIT PROFESSIONAL? (Continued)

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With the E-Sign Act, a credit professional may accept a completed credit application electronically, with e-signature, to form a binding contract, as opposed to the customer downloading the application from the vendor's web page, filling it out and signing it and faxing or mailing the completed credit application with handwritten signature. The credit professional may also receive completed guarantees in the same manner and form a binding contract.

Likewise, the E-Sign Act aids e-checks and e-payments as businesses may sign checks electronically. The FTC's recent report underscores that e-signatures are legally enforceable and e-signatures will continue their growing acceptance to document an e-credit sale. The electronic credit department continues to expand.

STANDBY LETTER OF CREDIT PROCEEDS BELONG TO CREDITOR NOT BANKRUPTY ESTATE(Continued)

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drew down on the L/C postpetition. The bankruptcy trustee sued the creditor to recover the L/C proceeds. The creditor objected, complaining that the L/C was an independent obligation of the bank, and that trustee could not recover the L/C proceeds as they were not property of the bankruptcy estate.

Letter Of Credit

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

L/C's are independent from the underlying contract between the customer and the vendor. The bank honoring the L/C is concerned only to see that the documents conform with the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the customer. The bank need not look past the documents to examine the underlying sale of goods. Thus, a vendor 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.

What Is Property Of Bankruptcy Estate?

The Bankruptcy Code defines property of the estate expansively to include virtually all property in which a debtor has an interest. But does the property interest include proceeds from an irrevocable L/C drawn-down postpetition?

Bankruptcy And Letters Of Credit

The *Farm Fresh* court agreed with the creditor that its draw-down of the L/C postpetition did not violate the automatic stay and the proceeds were not property of the bankruptcy estate. The court stated:

"[N]either the letter of credit nor the proceeds were property of the debtor's estate, and therefore the trustee may not maintain the instant lawsuit to recover them. . . The payment under the letter of credit was not a postpetition transfer that required court approval. This is because 'property of the estate does not include the proceeds of a letter of credit paid to a creditor of the debtor who is a beneficiary of the letter. (Citation omitted)"

The court dismissed the trustee's lawsuit and the creditor kept the L/C's proceeds. The court recognized that the L/C is independent from the underlying contract between the debtor and the creditor, and because of this independence principle, the creditor's draw-down of the L/C postpetition did not violate the automatic stay.

L/C Can Make The Sale

Credit professionals are in the business of "making the sale", which may mean looking to a credit enhancement, such as an L/C, to reduce or eliminate credit risk. An L/C may provide the credit professional with the opportunity to make the sale, and also maximize the recovery in the event of a customer's liquidation or bankruptcy, thereby maximizing the sale and minimizing the risk.

2. *In re Farm Fresh Supermarkets of Maryland, Inc.*, 257 B.R. 770 (Bankr. D. Md. 2001).

3. *Farm Fresh Supermarkets*, 257 B.R. 773.

WORKING WITH YOUR LONG-TERM CUSTOMER THAT IS FINANCIALLY TROUBLED MAY HELP YOU BEAT A PREFERENCE ACTION (Continued)

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whether a vendor must disgorge payments as a preference from a long-term customer. The court gave special deference to the vendor's ordinary course of business defense in light of the long-term trade relationship between the debtor and vendor, even though the debtor paid well outside of invoice and with post-dated checks. The court's ruling and its meaning to vendors is considered.

The Trade Relationship

The vendor owned radio stations, and the debtor had been a long term advertiser of the vendor's stations. Invoice terms were 30 days net. The debtor consistently paid its invoices between 90 and 120 days. The vendor's other customers usually paid between 60 and 90 days. The vendor and the debtor modified their trade terms wherein the vendor agreed to accept 90 day payment terms, in exchange for additional business. The debtor began post dating checks. The debtor filed chapter 7 liquidation. The bankruptcy trustee sued the vendor to recover payments within 90 days of the bankruptcy filing.

The Preference Action and the Ordinary Course of Business Defense

The Bankruptcy Code vests the debtor (or trustee if one is appointed) with far-reaching powers to avoid transfers of assets and monetary transactions prior to a bankruptcy filing. The power to avoid preferential transfers is one of the most powerful weapons a trustee has. The Bankruptcy Code defines a preference expansively to include nearly every transfer by an insolvent debtor 90 days prior to bankruptcy. The purpose of the preference provision is two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period are avoidable. To protect those transactions which replace value to the bankruptcy estate previously transferred, the Bankruptcy Code carves out seven exceptions or defenses to the trustee's recovery powers. The most commonly asserted exception by trade creditors is the ordinary course of business defense. That defense protects payments, in all or part, received by an unsecured creditor within 90 days of the bankruptcy from recovery where the creditor establishes certain elements detailed below. The policy supporting the ordinary course of business defense is two-fold: (1) protect customary transactions, and (2) encourage creditors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy.

To qualify for the ordinary course of business defense, a creditor must establish that the payment is ordinary as between the parties and that the payment is ordinary in relation to prevailing business standards. The court determines a debtor's ordinariness of payments through comparison with prevailing business standards, which includes common terms used by other trade creditors in the same industry facing similar problems.

The Flexible Ordinary Course of Business Standard

After remand, the court concluded that the relationship between debtor and vendor was long standing and established well before the debtor's slide into bankruptcy. The court held that the vendor was allowed some leeway from the industry standard, and that the timing and method of payment fell within the sliding scale window of industry standards. The court noted that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary. The court also noted that the the purpose of the exception is to leave undisturbed normal financing relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy. The court rewarded the vendor for the long-term trade relationship:

"[T]he more cemented, as measured by its duration, the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain within the safe harbor of section 547(c)(2). The likelihood of unfair overreaching by a creditor, to the disadvantage of other creditors, is reduced if the parties sustained the same relationship for a substantial time frame prior to the debtor's insolvency."

Thus, the court looked at the history of the parties' relationship and credit terms to determine whether these were cemented prior to debtor's slide into bankruptcy.

The Lesson for the Credit Professional

The court's opinion underscores that a credit professional should mount a vigorous preference defense when a preference demand letter or preference complaint is received. The court's opinion provides encouragement for a credit professional that even if the debtor paid well outside of invoice and the debtor paid with post-dated checks during the preference period, even though the debtor had paid this way, the vendor may have an ordinary course of business defense. The court made a special point that the more established the trade relationship between the parties, the more that a vendor will be permitted to deviate from the industry standard and still qualify for the ordinary course of business exception.

2. *In re Bee Furniture Co., Inc.*, 250 B.R. 757 (M.D. Fl. 2000).

BE MINDFUL OF EQUAL CREDIT OPPORTUNITY ACT REGULATION WHEN TAKING SPOUSAL GUARANTEE (Continued)

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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 may 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.

Obtaining A Spouse's Personal Guarantee

ECOA also bars a vendor demanding a guarantee from a spouse unless a vendor first determines that the applicant, say a corporation, does not qualify for the credit on its own. ECOA also does not permit a vendor to require a spouse to co-sign a personal guarantee if that spouse is not directly involved with the applicant. Unless the vendor can show that the applicant, say a corporation, was independently creditworthy, or that the spouse was involved in the applicant's business, the vendor can not condition the sale on the spouse being a co-guarantor.

Alleged ECOA Violation Do Not Invalidate Guarantee

The facts supporting the Appellate Court's opinion is that the applicant requested credit. The spouse, who was not involved in the business, guaranteed the debt. The creditor sued the spouse on the guarantee when the debt was not paid. The spouse responded to the creditor's lawsuit by contending that the creditor had violated ECOA as the applicant was independently creditworthy. The spouse contended the guarantee should not be enforced because of the ECOA violation and that she was entitled to damages. The court disagreed and denied the spouse's claims of ECOA violations. The court referred the case to the state supreme court to resolve issues on application of ECOA and counterclaims.

A Reminder When Taking A Personal Guarantee With A Spouse

A personal guarantee provided by a company's officer, and spouse, of a corporation's debt is a method to increase the credit professional's security. However, be mindful of your credit application that includes a form spousal guarantee. ECOA may restrict your taking of this guarantee. A guarantor always looks for ways to escape liability from the guarantee. Don't have an ECOA violation result in your guarantee being ruled unenforceable.

1. Boone National S&L v. Crouch, 2001 WL 182415 (Mo. App. W.D.)

PARTICIPATING OWNERS: ENFORCING A MECHANICS' LIEN FOR MATERIALS AGAINST A NON-CONTRACTING PARTY (CONTINUED)

(continued from page 2)

Improvements to Leasehold Estates

A payment issue may arise when materials are supplied for a project involving improvements to a leasehold estate. Generally, the leaseholder, not the property owner, contracts to construct the improvements. However, the law of fixtures regards a building as becoming a part of the land after it is constructed, belonging to the property owner.

If the materials are furnished to a leaseholder for improvements, then the property owner may not be held liable for the payment, despite the owner's benefit of improved land. Accordingly, if the leaseholder defaults or claims bankruptcy, a materials' lien may have little or no effect.

Where Owner May Not Be Liable For Improvements

The states have taken two approaches to balance the unfairness of subjecting a non-contracting owner to a lien and the possibility of unjust enrichment. Under the first approach, a non-contracting owner is subject to the mechanics' lien if there is notice of the improvements, unless the non-contracting owner objects to the improvements and/or notifies the parties of its nonresponsibility.

Generally, the statement of nonresponsibility is in writing and filed with the appropriate state authority within ten days from the date of notice that improvements are being made to the property. The alternative theory is that a non-contracting owner is only bound if written assent subjects his interest to a lien. If the non-contracting owner has taken these steps to avoid liability, then the material supplier may have little or no recourse for payment except through the leaseholder. The material supplier may have to absorb a total loss, if the leaseholder defaults or files bankruptcy. The only recourse may be to pursue the non-contracting owner under an exception.

Participating Owners Liable For Improvements Despite Notice of Nonresponsibility

The material suppliers' only recourse may to claim that the non-contracting owner is a "participating owner" of the improvement project. Under the participating owner doctrine, suppliers have been increasingly successful in imposing mechanics' liens on a non-contracting owner's property interest.

To obtain this result, suppliers have used the non-contracting parties' involvement and control to obtain payment for the materials furnished. A mechanics' lien will attach to the non-contracting owner's interest in the leased property if substantial leasehold improvements are a condition to the lease, or the non-contracting party has played an active and substantial role in the improvements.

In determining whether a non-contracting owner may be held liable for a mechanic's lien as a participating owner, notwithstanding the posting of a notice of nonresponsibility, courts have considered the following factors: first, where substantial improvements are a condition to the lease, and but for those improvements, would the parties have consummated the lease; second, did the non-contracting owner retain substantial control over the improvements, including approval of plans, specification, and reversion of improvements upon termination; and third, the courts consider the expertise of the non-contracting owner. In consideration of these factors, the non-contracting owner must participate more than providing cash incentives to complete improvements.

The End Game: Getting Paid With Priority

The mechanic's lien is a useful tool for getting paid. If the materials are supplied to improve a leasehold estate, then monitor the actions of the property owner carefully. If the leaseholder defaults, then the material supplier may want to file a mechanics' lien against the property and pursue the property owner.

Additionally, mechanics' liens receive priority over other creditors, including judgment and mortgage liens. Depending on the state, mechanics' liens can receive significant favor and may subordinate any other lien, mortgage, deed of trust, or other encumbrance. Furthermore, if a priority lienholder failed to record or give notice, the mechanic's lien will receive priority.

IS YOUR VENTURE CAPITALIST-FINANCED CUSTOMER ABLE TO PAY FOR THE CREDIT SALE? SHOW ME THE MONEY: THE CASH-BURN RATE IS MORE IMPORTANT THAN EVER (Continued)

(continued from page 5)

sional and on her local NACM affiliate, CMA Business Credit Services.

CMA Business Credit Services helped Cathy form an educational group devoted to this new niche market and the result is the creation of the Southern California E-Merging Companies Education Group, which meets quarterly. The group has defined an e-merging company as any business not generating revenue from operations or traditional sources but from venture capital investment or equity funding. The purpose of the group is to share ideas and techniques through speakers and member expertise and ideally develop new models for credit extension to e-merging companies. There is also a Northern California chapter of the E-Merging Companies Education Group.

High Cash Burn Rate and Zone of Insolvency Cause Bondholders to Sue

In the telecommunications industry, cash burn rates are especially critical. Some creditors, especially bondholders, have attempted to restrict telecom companies from using cash out of fear that they will go unpaid.

Creditors, with a close watch on the cash burn rate, are acting collectively earlier out of concern that the telecom may not pay. Bondholders have recently sued to restrict a company's use of cash out of concern the company's cash-burn rate will render it insolvent and unable to pay creditors. Creditors are demanding payment prior to a default as they contend that the company's board of directors owes a fiduciary duty to creditors when the company is insolvent or near insolvent. Creditors are contending that cash-burn rates of many companies are outstripping revenues and such companies should be liquidated to satisfy creditors' claims rather than continue to operate.

Still Opportunity For Sales

With the downturn in the economy and limited VC funding, a dot-com's cash-burn rate is key with any credit analysis. As Newport Corporation shows, a variety of credit options allows a vendor to make the sale and minimize risk in a down round of VC funding.

Cathy Markowitz is the Domestic Credit Professional for Newport Corporation, located in Irvine, California. Her e-mail is cmarkowitz@newport.com.

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