Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

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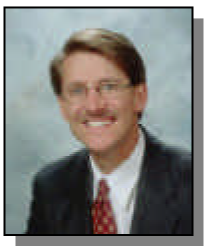
Developments in Commercial, Creditors' Rights, E-Commerce, and Bankruptcy Law of Interest to the Credit and Financial Professional

CALIFORNIA PRIVACY LAW MAY HAVE FAR REACHING IMPACT ON ELECTRONIC CREDIT DEPARTMENT



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With the arrival of the Internet and sharing of a customer's financial information electronically, a customer's privacy rights to financial information is now at the forefront of legislation passed by the California legislature, and being considered at the federal level. Bill SB1386, recently adopted by the California legislature, creates a duty for companies to protect electronic personal information from being disclosed, and requires companies to notify customers when their electronic information has possibly been misused. Violation of SB1386 may be the basis of a lawsuit.

National privacy rights groups are promoting SB1386 as model legislation on the federal level to combat the dramatic rise of the crime identity theft. Criminals use stolen personal financial information to get credit cards and checking accounts in the victim's names. The FTC reports that over nine million Americans were the victims of identity theft last year, costing victims $5 billion and costing business approximately $50 billion. The victims spent almost 300 million hours working out the identity theft problems.

Courts are wrestling with the breadth of a customer's privacy rights and duties owed to customers, and much litigation is anticipated over this legislation.

Privacy groups and the press have made privacy rights a high profile topic. Indeed, according to a Wall Street Journal poll, Americans view loss of privacy rights as of great concern. Balancing the breadth of privacy rights and legislation is a difficult task, as information that is protected under privacy legislation means groups are denied access to financial information they believe they have a right.

Compliance with the new privacy legislation may be expensive. Consulting firms now sell privacy audits to businesses to comply with privacy legislation and enforcement. With the arrival of new privacy legislation, it is expected that class action attorneys will gear up with private cause of action claims against business for negligence claims for failure to keep a customer's private financial information secure.

California Privacy Law/SB1386

A. Purpose

SB1386 requires a company that does business in California to notify consumers when there may have been unauthorized access to their electronic personal information. SB1386 also requires that safeguards are in place to protect a customer's private information. SB1386 is a California statute that may apply to all states. The law is intended to protect customers from the risk of identity theft through notifying them of

(Continued on page 4)

CONTENTS

IS PAYMENT ON A FIRST-TIME SHIPMENT WITHIN THE ORDINARY COURSE OF BUSINESS?

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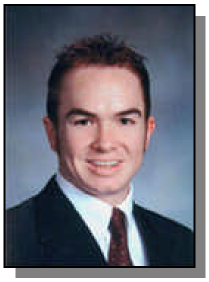
Your company has just received a first-time order from a company you know is having financial difficulty. As a credit manager, do you agree to take the order and extend credit? The Pennsylvania bankruptcy court's decision in *In re Forman Enterprises, Inc.* encourages you to do so.

In *In re Forman Enterprises, Inc.*, the debtor, a retailer of casual clothing, placed an order with Golden Knitting Mills, Inc. for sweaters valued at $115,200. It was the first transaction between the parties, with stated invoice terms of "NET 30". The Debtor failed to pay within terms, and several calls were placed by Golden in an attempt to collect the past due amount. Golden went so far as to re-send the invoice to the Debtor's Chief Financial Officer, and finally spoke with the CFO concerning the delinquent payment. The Debtor agreed to pay the full amount owing, and, in return, Golden shipped additional goods to the Debtor. A week later, 19 days after the due date, the Debtor paid Golden $115,200.

The trustee filed a preference action against Golden seeking to recover the full $115,200. At trial, the court acknowledged that several courts in other jurisdictions have adopted a *per se* rule that first-time transactions between a debtor and creditor can never qualify as an ordinary-course transaction. The ***Forman Enterprises*** court

(Continued on page 6)

AN ANTECEDENT DEBT IS A CONDITION TO A PREFERENCE



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What is the correlation between "antecedent debt" and a "preferential payment?" If a payment on antecedent debt is made by a debtor to a creditor during the preference period (i.e. within 90 days of the bankruptcy filing), the money may be avoided by the court and returned to the debtor's estate. Theoretically, the preferential transfer will be returned to the debtor's estate to enable an equal distribution for unsecured creditors. To illuminate the United States Bankruptcy Code, we must define what is an "antecedent debt," and how does this effect a payment made within the "preference period."

To review, the bankruptcy trustee may avoid a payment made by a debtor to a vendor within 90 days before the bankruptcy filing if the court finds that certain elements are established. According to section 547 (b) of the bankruptcy code, the trustee has the burden of proving:

(1) the payment was made to a creditor,
(2) the payment was for or on account of an "antecedent debt,"
(3) the payment was made while the debtor was insolvent,
(4) within 90 days before the bankruptcy filing (or one year if such creditor was an insider), and
(5) the creditor received more than it was entitled.

In *In re Vanguard Airlines, Inc.*, 295 B.R. 329, 335 (Bankr.W.D.Mo. 2003), the court found that payments made to a vendor in the 90 days before the debtor's bankruptcy filing were not on account of an antecedent debt, and thus not preferential. Accordingly, the vendor was able to keep a large portion of the payments made by the debtor during the preference period. The court reasoned that a debt to the vendor did not occur until the vendor provided the contracted services. Consequently, the payments to the vendor were for future services, not antecedent debt.

How does the court determine what a debt is and when it is incurred? Pursuant to the bankruptcy code, a debt is a "liability on a claim." *In re First Jersey Securities, Inc.*, 180 F.3d 504, 511 (3d Cir. 1999). Also, pursuant to the bankruptcy code, a claim is broadly defined as a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal equitable, secured, or unsecured. "A debt is 'antecedent' if it was incurred before the allegedly preferential transfer. A debt is incurred 'on the date upon which the debtor first becomes legally bound to pay.' " *In re Jones Truck Lines, Inc.*, 130 F.3d 323, 329 (8th Cir. 1998). Typically, a debtor becomes liable to a vendor when a resource is consumed or a service performed, not when the vendor decides to bill the debtor.

In *Vanguard Airlines*, the debtor asserted that it had a legal obligation to pay for estimated charges for a particular month when it received an invoice at the beginning of that month. However, an invoice does not create or establish a debt, nor does it give a creditor a right to payment. An invoice estimating the cost of services to be provided in the future does not create a debt. The debt arises when the debtor receives the goods or services, not when the vendor decides to invoice the debtor. *Vanguard Airlines*, 295 B.R. at 334.

(Continued on page 6)

FROM THE PUBLISHER:

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Guest Column

TRUST FUND LAWS TRUST FUND AGREEMENTS

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Since the upswing in bankruptcies a couple of years ago, vendors have been searching for relief from insolvencies. Creditors have an important advantage and lower risk when doing business in a state with a Trust Fund Statute. No matter where you are doing business, you can also add a voluntary Trust Fund Agreement in your credit applications, quotes, proposals or other contracts.

Trust Fund Agreements

- Are simple, requiring only one or two sentences
- Are cheap and unobtrusive, with no court filings and no cost to a customer to establish
- Can give you title to a bankrupt's assets and avoid general unsecured creditor status
- Can beat blanket security interests granted by your customer to their bank
- Can beat preference claims in bankruptcies

In the event of debtor insolvency or bankruptcy, any creditor wants to have that "something else" to stand apart from the general unsecured creditors. General unsecured creditors will have to participate in the bankruptcy process and hope that the debtor will have unencumbered assets for a distribution. This usually results in little or no payment. Secured creditors may be able to stay out of bankruptcy court altogether and have a much better chance of getting their money. Payment bonds, personal guarantees, mechanic's liens, or security agreements help creditors to avoid general unsecured status. Trust Fund Laws and Agreements are an important and under utilized opportunity.

Suppose a bankrupt debtor is the trustee on his niece's college tuition trust fund. The bankruptcy debtor's creditors cannot attach this college trust fund, because it is not the bankruptcy debtor's money. The money belongs to the niece. The trustee has only "legal" title. The niece is the "beneficiary" of the trust and has "equitable" title to the money.

Some states have trust fund "statutes" or laws to protect subcontractors and suppliers in

(Continued on page 5)

SARBANES-OXLEY ACT & UPSTREAM CERTIFICATION: TYING THE CREDIT PROFESSIONAL TO THE ACCURACY OF FINANCIAL STATEMENTS

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The Sarbanes Oxley Act of 2002 (SOA) was signed into law to combat the wave of accounting and financial reporting scandals and corporate bankruptcies, from Enron to Worldcom to Global Crossing. SOA focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. SOA requires more accurate financial disclosure and reporting from public companies then ever before. All financial information must accurately present the company's financial conditions and results of operations for the period.

To achieve this, and hold officers accountable, SOA requires the CEO and CFO to certify that the company's periodic reports do not contain untrue statements of a material fact. SOA has earmarked over $700 million for the Securities and Exchange Commission (SEC) to investigate and prosecute corporate fraud. The SEC has also recently backed a rule in support of SOA, that goes into effect in June 2004, requiring management to disclose in their annual reports whether they have proper internal financial controls and accounting procedures to prevent fraudulent reporting. This new rule places further burdens on the accuracy of financial information the company discloses, and the accounting firm that audits their financials.

To comply with the certification requirements, some public companies are requiring heads of financial departments, such as the director of credit, to swear on the accuracy of their own numbers reported to management.

What are the implications for the credit professional signing what is referred to an upstream certification? Will the certification affect how the credit professional reports its financials?

Federal Government Overview of Financial Reporting

SOA provides that the Security and Exchange Commission (SEC) enforces the legislation and has earmarked $766 million for SEC enforcement. Much of this enforcement comes through SOA's creation of the Public Company Accounting Oversight Board (Board). The SOA grants the Board supervisory, investigative, disciplinary, and enforcement powers over public accounting firms. The Board will enforce mandatory registration of firms that prepare audit reports for public companies and establish auditing, quality control, ethics and independence standards relating to preparation of audit reports. The Board must also enforce other standards that it, or the SEC, determines are "necessary and appropriate." The Board will consist of five members - two CPA's and three non-CPA's.

Attempting to Hold Officers Accountable

The CEO and CFO must sign a certification that the company's periodic public financial reports do not contain untrue statements of a material fact. All financial information must accurately present the company's financial conditions and results of operations for the period. Public companies must now establish and maintain an overall system of disclosure controls and procedures that is adequate to ensure that the CEO and CFO receive all material information necessary to generate accurate quarterly and annual reports.

Certifying officers must establish internal controls to ensure that employees provide material information regarding the company and its subsidiaries. Signing officers must also acknowledge that they have evaluated the company's internal financial controls within the 90 days before the filing of the report; that they have reviewed the report and it is accurate; that financial statements fairly present the financial condition; and is answerable for maintaining the financial controls.

The report must include conclusions of their evaluation. Certification must also state that the CEO and CFO have reported to the auditors and audit committee of the company all information regarding significant deficiencies in internal controls that could adversely affect the company's ability to provide an accurate report.

The CEO must sign the company's tax returns. CFO's are concerned that errors in reported financial information may create personal liability, or even serve as a test case for the SEC. An officer or director that knowingly makes a false certification may be fined up to $5 million and jailed for

(Continued on page 6)

SUPREME COURT SPEAKS TO VENDORS ABOUT SETTLING FRAUD CLAIMS AGAINST CUSTOMERS WHO LATER FILE BANKRUPTCY

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On occasion a customer may misrepresent its financial condition to obtain product on credit from a vendor. The vendor may have fraud claims should the customer fail to pay for the credit sale. To avoid the costs of litigation, the parties may agree to settle the dispute, with customer agreeing to pay over time on the delinquent account. But what happens should the customer file bankruptcy prior to paying off the delinquent account? Is the vendor's claim discharged in the bankruptcy, or rather, does the customer's claim (customer is a sole proprietor) survive the bankruptcy as it may be found nondischageable? Does the settlement agreement serve to waive the vendor's fraud claim? The U.S. Supreme Court recently considered this topic.

In *Archer v. Warner, ___U.S.___ (2003)*, the owners (debtors) sold their business, but were later sued by the buyers (creditors), alleging fraudulent misrepresentation arising out of the sale. The parties eventually settled. The settlement agreement was part cash and part installments. The creditors signed releases discharging the debtors from all claims arising out of the litigation, other than the debt owing. The creditors brought a collection suit when the debtors defaulted on the first payment of the settlement agreement. While this suit was pending, the sellers filed a personal chapter 13 bankruptcy, which was converted to a chapter 7.

The sellers then brought a nondischargeable action in the bankruptcy court seeking the debt due under the original settlement agreement and promissory note ride through the bankruptcy. The creditors realleged the fraudulent misrepresentations arising out of the initial sale of corporate assets in the nondischargeable action. One of the debtors denied any misconduct and asserted the affirmative defense of settlement of the original state court suit. The bankruptcy court ruled in favor of the debtor finding that the settlement created a novation, substituting a contract debt which

(Continued on page 7)

CALIFORNIA PRIVACY LAW MAY HAVE FAR REACHING IMPACT ON ELECTRONIC CREDIT DEPARTMENT

(continued from page 1)

misuse of their personal information so they can take steps to protect their assets.

B. Key Terms of SB1386

1. Electronic Credit Department

SB1386 applies to those companies that store personal information on computers.

2. What Information is Covered?

SB1386 covers personal information, which is defined as a person's first and last name, in combination with the Social Security number, credit card number or driver's license number.

3. What is a Security Breach

SB1386 requires notification upon a security breach. However, the statute does not define what constitutes a security breach. The statute requires notification even where the company only suspects there has been a breach.

4. Must a Company reside in California?

SB1386 applies to companies outside of California that do business within the state. In an extreme example, a company with but a single California customer, and no offices, employees or computers within California, may be required to report a breach of security.

C. Notice Requirement

SB1386 requires a company give prompt notice to customers after a security breach. Notice may be via e-mail or regular mail. Should a company fail to disclose a security breach, it may be liable even if the customer's personal information is never used. A company is not required to notify law enforcement.

D. Complying with SB1386

If SB1386 applies to your customers, the following steps should be considered.

1. Encryption

SB1386 may result in companies doing business in California improve their data security. SB1386 is silent as to the mechanics for detecting and responding to a security breach. However, a company that encrypts the personal data may be exempt from SB1386.

2. Privacy Policy and Notices

The credit professional should consider how customer information is stored. People's names, such as with a guarantor or an individual credit card paying customer, should be kept separate from their other personal information, e.g., Social Security number and credit card number.

The credit professional should have its company adopt a policy as to notification of California customers in the event of a security breach, storing private information and sharing private information with third parties. To reduce the risk of a security breach, employee access to customers' private financial information should be restricted.

3. Security

In addition to privacy notices, SB1386 requires a customer's information is secure. Personal information should be protected by reasonable security safeguards against such risks as loss or unintended disclosure of customers' information.

4. Written Manual

The vendor should have a company policy manual advising of its privacy policy.

5. Training

Train credit and sales as to the privacy policy. SB1386 applies to agents of the company cloaked with authority to request personal financial information from a customer. Perhaps the biggest risk for a company in this area is the theft of a company laptop. Some companies have employed a Chief Privacy Officer or an information manager to comply with privacy policy.

6. Credit Application

The credit application dealing with the sole proprietor and general partner should disclose the policy of keeping personal financial information secure.

7. Personal Guarantee

The personal guarantee should likewise disclose the policy of keeping personal financial information secure.

8. Privacy Audit

Big Five accounting firms and consulting firms have launched specialized units that sell privacy audits to comply with legislation. Consultants review a company's computer databases to determine how personal identifiable information is maintained.

E. Violation of SB1386

SB1386 creates the right for customers to sue to recover damages for violation of the statute. SB1386 is silent as to damages, although a company may see claims for costs associated with identity theft as a result of a security breach, as well as emotional distress and class actions.

Credit Department's Privacy Policy

A customer's privacy rights are at the forefront of legislation and regulation, and appear a hot topic into the future. Courts will be asked to interpret the legislation. As technology continues to shape the electronic credit department and the ease in which customer information may be collected and shared, a credit professional should be mindful of a customer's privacy rights and enactment of new legislation in this area.

Given this, the credit department should consider implementing a privacy policy of the customer's financial information, especially as the department goes electronic in sharing information, and the company is operating its business over the Internet. The policy may address the type of information it collects and how it uses and distributes the information to ensure the confidentiality of information. Presently, there is no state or federal law that requires a privacy policy, but considering the number of privacy laws being considered at the state and federal level, it may be a matter of time before such policy becomes mandatory.

TRUST FUND LAWS TRUST FUND AGREEMENTS

(Continued from page 2)

the construction industry, including Maryland, New York, New Jersey, Illinois, Minnesota, Wisconsin and Michigan. When a general contractor receives payment from the construction project owner, the general contractor holds funds in trust for the benefit of the subcontractors and suppliers. Subcontractors then hold funds in trust for their suppliers and sub-subcontractors.

In some states, such as Maryland, the officers and directors of a company holding trust funds are also personally liable to make sure that trust funds get to the proper subcontractor and supplier beneficiaries. This works very much like personal liability for federal "941" income withholding taxes. In addition to having special status if the trustee contractor files bankruptcy, the trust beneficiary vendor may also have a personal guarantee from the officers and directors of the bankrupt debtor.

Even in states without trust fund laws, it is possible to create a trust fund relationship by agreement. This works just like a bank trust fund or the college tuition trust fund for the niece and would apply in any non-construction industry.

Joint check agreements can create trust relationships. The status of joint check agreements is often debated in bankruptcy. Some courts have held that a joint check agreement is just another unsecured contractual promise. Other courts, however, have held that funds held pursuant to a joint check agreement are funds held in trust, similar to trust fund laws. The conclusion will depend on the wording in the joint check agreement. As discussed in earlier newsletters on our website, the wording and effect of joint check agreements vary tremendously.

It is possible, however, to add clear trust language to a joint check agreement, credit agreement, proposal, quote or to any contract with just a few sentences.

> Customer agrees that all funds owed to Customer from anyone or received by Customer, to the extent those funds result from the labor or materials supplied by Seller, shall be held in trust for the benefit of Seller ("Trust Funds"). Customer agrees it has no interest in Trust Funds held by anyone and to promptly account for and pay to Seller all Trust Funds.

We believe that this language creates a trust fund relationship that should work just like the trust fund laws. Your debtor agrees that all funds received are held in trust, to the extent funds result from your labor or materials. If your debtor files bankruptcy, these funds will not be property of the bankrupt estate. You will not need to share with the general unsecured creditors and should be able to keep these funds as the trust beneficiary.

This language should also be relatively easy to "sell" to a customer on a credit agreement or quote. The customer certainly intends to pay you promptly on receipt of funds. That is all this language says. It does not create any additional burden or cost on the customer. The issue is whether you would have to "share" this receivable with all of your customer's other creditors in the unlikely event of insolvency. This language allows you to identify your customer's receivable as produced or created by the labor and materials you supplied and claim ownership of that receivable.

Since your debtor is never the owner of trust funds, it is also impossible for the debtor to grant a security interest in trust funds. The trustee could not give away or sell trust property, since a trustee does not have title. The beneficiary of the trust could claim ownership of the trust property, even in the hands of third parties. By the same token, a trustee cannot grant an effective security interest in trust property. The trustee has no good title to sell, give away or grant a security interest in trust property.

Accordingly, trust fund laws or agreements are one way that a vendor can gain priority over a customer's bank that has a blanket security interest on receivables. This also makes sense. You are essentially saying to a customer that you will not give them the value of your labor and materials, if some other lender will have priority over the receivable that is generated by the value you provide. You can refuse to supply labor or materials unless you will have absolute first priority to the value you provided. This absolute first priority is a trust fund agreement.

In the event of bankruptcy, the trust funds held for the benefit of subcontractors and suppliers do not become a part of the bankruptcy estate. The creditor may need to get appropriate bankruptcy orders, but may be entitled to payment directly from an owner or general contractor. A trust fund claimant may even be able to obtain payment from the bankruptcy estate, by bankruptcy court order, since trust funds are not property of the bankruptcy estate and always belong to the beneficiary.

Trust fund laws or agreements can also be very helpful in "preference" litigation. If a creditor received payments less than ninety days before a bankruptcy, the creditor may have to give the money back as a "preference." If a trust fund law or agreement applied, however, the payment cannot be a preference. The debtor was giving you your own money. It was never the debtor's property and was not a payment from the debtor.

The ability to trace funds may be a limiting factor. We all know that a supplier must show that its materials went into a construction project in order to establish mechanic's lien rights. Similarly the supplier must show that funds held came from the construction project or the trust fund agreement, in order to establish trust fund rights.

We hope these articles are helpful to you in understanding some of the concepts and issues involved in trust laws and agreements. There is much court case law explaining trust fund laws. Private trust agreements, such as bank trusts, have also been around a long time. The use of trust fund language in a construction contracting context is an innovation, however.

We expect to have a more detailed chapter on Trust Funds by January 2004. Visit the website at www.fullertonlaw.com

James D. Fullerton is a partner in the law firm of Fullerton & Associates, with attorneys licensed in Virginia, Maryland, Pennsylvania, New York, New Jersey, and the District of Columbia. The firm represents owners, design professionals, suppliers, subcontractors, general contractors and other members of the real estate and construction industries region-wide.

SARBANES-OXLEY ACT & UPSTREAM CERTIFICATION: TYING THE CREDIT PROFESSIONAL TO THE ACCURACY OF FINANCIAL STATEMENTS

(Continued from page 3)

up to 20 years.

Upstream Certification and the Credit Professional

Known as upstream certification, directors of credit and managers of credit departments are being required to sign letters stating that their units' reported numbers are accurate. Such certifications could provide some protection for CFOs as it shows that management took reasonable steps to verify the numbers. In other words, the CFO may view the upstream certification as a form of risk management. But what of the credit professional? A credit professional who knowingly – or perhaps negligently – signs a false upstream certification could be found liable by the SEC. As noted the SEC is vigorously pursuing the investigation and prosecution of SOA. Indeed, the SEC is taking a bottom up approach to investigating compliance with SOA. To make matters worse, the recent corporate scandals have dramatically changed the availability of D&O insurance coverage at the moment the companies have the greatest need for insurance. Further, the typical firm's directors' and officers' coverage does not extend to credit professionals.

IS PAYMENT ON A FIRST-TIME SHIPMENT WITHIN THE ORDINARY COURSE OF BUSINESS?

(Continued from page 1)

rejected this position, however, and asserted such a rule would discourage rather than encourage first-time creditors from doing business with a struggling debtor. The court found that the transfer was not made outside of the ordinary course of business, and found in favor of Golden.

It is important to note that the court underscored the importance of the second shipment made by Golden. With an interesting interpretation on the communications between the parties, the court found that the communications leading up to payment were a "prelude to [the debtor] ultimately agreeing to ship the second order of sweaters," and rejected the trustee's argument that the tactics employed by Golden placed undue pressure on the Debtor to make the transfer.

In its decision, the *Forman Enterprises* court recognizes the difficulties encountered by debtors to find new suppliers willing to give credit in troubled times, and the importance of encouraging creditors to do so. The decision is a step in the right direction toward giving creditors the assurance they need before extending credit to a first-time customer.

AN ANTECEDENT DEBT IS A CONDITION TO A PREFERENCE

(Continued from page 2)

To delve further into "antecedent debt," consider the policies underlying the preference section of the bankruptcy code. To promote equal distribution to a debtor's vendors, the bankruptcy code was designed to prevent vendors from "racing to the courthouse to dismember the debtor during its slide into bankruptcy." *First Jersey*, 180 F.3d at 511. If "antecedent debt" was calculated from the date of invoicing instead of the date of obligation, the creditor would be left with the discretion to determine the date the obligation was incurred.

Not only would this create the possibility of unequal treatment of similarly situated creditors, but also the opportunity for a particular creditor, who foresees that his debtor is approaching bankruptcy, to secure preferential treatment for himself by the timing of his bill. Hence, in the pursuit of justice the courts have taken the liberty to define what a debt is, when it is incurred, and how a recent payment to an unsecured vendor may be avoided.

Although the bankruptcy code is designed to assist debtors through tremendous financial difficulties, the court will protect vendors by requiring due process of the law before any monies are avoided through preference litigation.

SUPREME COURT SPEAKS TO VENDORS ABOUT SETTLING FRAUD CLAIMS AGAINST CUSTOMERS WHO LATER FILE BANKRUPTCY

(Continued from page 3)

was dischargeable for the fraud claims which were not.

Elements Of A Nondischargeable Action

Should a debtor that files bankruptcy defraud a vendor, the vendor may be able to have its claim "ride through" bankruptcy. A vendor may also seek to have its particular debt to be ordered non-dischargeable, or object to the debtor's discharge, wherein all of the debtor's debts are ordered non-dischargeable.

The most common causes of action to exclude particular debts from discharge are: (1) fraudulently incurred obligations; (2) fiduciary fraud and embezzlement; and (3) willful and malicious acts.

The nondischargeable provisions provide that the debtor must be an individual. Thus, if the vendor sold to a sole proprietorship, or holds a personal guarantee on a sale to a corporation, LLC or partnership, the vendor has a claim against an individual. There are no nondischargeable claims against a corporation, as the corporation is not entitled to a discharge in bankruptcy. If the vendor sold to a corporation, and the insider of the corporation filed bankruptcy, the vendor may still have a nondischargeable claim against the individual, but must establish an alter ego claim against the insider.

Where property is obtained by the debtor's false pretense, false representation or actual fraud such claim may be excepted from discharge. Under the fraud nondischargeable provision, the vendor may establish either oral or written fraud by the debtor. With the oral fraud, the vendor must establish fraud and its reasonable reliance on the debtor's representation. If the fraud is in writing, the vendor must establish that the false financial statement is materially misleading and the vendor reasonably relied on the false financial statement.

The vendor may also have its claim ride through bankruptcy where it can be established that the debtor defrauded the vendor while in a fiduciary capacity. The vendor may also have its claim ride through bankruptcy where the debtor committed a willful injury. Courts have found that where a debtor has converted a vendor's property, such as collateral subject to a purchase money security interest may result in a nondischargeable claim.

The U.S. Supreme Court Considers Non-dischargeability

The matter was appealed to the U.S. Supreme Court, as there was a split in decisions with the circuit courts of appeals. One view is that a settlement agreement does not distinguish a dischargeability claim under section 523 of the Bankruptcy Code, while the other favors the basic principle of encouraging settlements by way of freedom to enter into settlement agreements.

A majority of the Supreme Court found that, although the settlement agreement and releases may have served as a new agreement, the creditors were not barred from establishing the settled debt arose out of a fraudulent transaction that is nondischargeable under the Bankruptcy Code. The Supreme Court relied on a prior ruling from this court (Brown v. Felsen) finding that the court could look behind the settlement for facts showing fraud in the original action. The Supreme Court's decision highlights the Bankruptcy Code's underpinning that a dishonest debtor is entitled to discharge his debts. The good news for the credit professional is that the Supreme Court suggests that if the parties seek to settle their dispute, including a dispute arising out of fraud, a specific provision waiving the fraud claim should be included. Otherwise, the Supreme Court is resistant to allow a debtor to change nature of the debt (fraud claim to contract claim, which is dischargeable in bankruptcy) through a settlement agreement.

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Fall 2003

Blakeley & Blakeley continues to represent its vendor clients in the areas of creditors' rights, commercial litigation and collection, preference defense, credit documentation, bankruptcy and out-of-court workouts.

- ◊ Scott spoke to the ***National Electric Distributors Association*** in Irvine, CA regarding the ***Sarbanes Oxley Act.***
- ◊ Scott spoke to ***NACM/MidAtlantic*** regarding ***Article 9 of the Uniform Commercial Code.***
- ◊ Scott spoke to the ***NACM/Connecticut Fine Paper and Newsprint Group*** regarding ***Creditors' Rights and Bankruptcy.***
- ◊ Scott spoke to the ***National Group Management's Confection Group*** in San Diego regarding ***Hot Legal Topics for 2003.***
- ◊ Scott spoke to ***Orange County Credit Professionals*** regarding ***Escheatment***.
- ◊ Scott spoke to the ***NACM/Louisville's Speciality Chemical Group*** in San Diego regarding ***Bankruptcy and Creditors' Rights***.
- ◊ Scott spoke to the ***National Food Suppliers Group*** in Las Vegas regarding ***Preference and Bankruptcy Developments.***
- ◊ Scott spoke to ***NACM/Texas Telecommuncations Group*** in Las Vegas regarding ***Creditors' Rights***.
- ◊ Scott spoke to ***CMA/Computer Industry Credit Group*** regarding ***Credit Applications***: ***Recent Developments***.
- ◊ Scott spoke to ***NACM/Florida's Computer Industry Group*** in San Jose regarding ***Creditors' Rights***.
- ◊ Scott spoke to ***NACM/Florida's credit group*** in San Diego regarding ***Pre-Sale of Goods Legal Issues.***
- ◊ Scott spoke to ***Staffing Services Credit Group*** regarding ***Creditors' Rights.***
- ◊ Scott spoke to ***Reimer Reporting's Outdoor Products Group*** in Las Vegas regarding ***Involuntary Bankruptcy Petitions***.

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