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BANKRUPTCY REFORM ACT TAKING EFFECT SOON

AS OCTOBER 17 NEARS, CONSIDER CREDIT ENHANCEMENT TO REDUCE BANKRUPTCY RISK

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On April 20, 2005, the U.S. Bankruptcy Code was finally overhauled, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Reform Act). As discussed in my article, "AS OCTOBER 17 NEARS, WATCH FOR RED FLAGS THAT YOUR CUSTOMER MAY BE FIXING TO FILE BANKRUPTCY", the changes to the U.S. bankruptcy laws taking effect on October 17th will make the bankruptcy process more restrictive, burdensome and expensive for a vendor's customer, whether a corporation, LLC, partnership, sole proprietor as well as a personal guarantor, whether the customer files a Chapter 11 reorganization or Chapter 7 liquidation.

The press is reporting a meaningful increase in bankruptcy filings due to the Reform Act's October 17th deadline. In light of this, vendors may consider looking to credit enhancements and alternative payment mechanisms to reduce credit risk through October 17 for certain customers that may be determined as candidates that may file bankruptcy prior to the effective date of the Reform Act. In dealing with the customer that may be showing red flags of financial strain, creditors should look for the credit enhancement tool that is most readily converted into cash, and is unlikely to be affected by a customer's bankruptcy. Some of those alternatives are discussed below.

1. Letter of Credit

A letter of credit (L/C) is a promise by an issuer, the bank, to pay the creditor, 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 creditor. The customer pays the issuing bank a fee to issue the L/C. If the creditor submits proper documents upon default, the bank will pay the L/C and the 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 creditor. The bank without the consent of the creditor can modify a revocable L/C. The creditor can obtain a standby L/C, which assures payment after the customer's default. The creditor 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 creditor. The bank honoring the L/C is concerned only to see that the documents conform to the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the customer.

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IS A PAYMENT MADE WITHIN CREDIT TERMS ALWAYS PROTECTED BY THE ORDINARY COURSE OF BUSINESS DEFENSE? -MAYBE UNDER THE BANKRUPTCY REFORM ACT

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In the face of bankruptcy, a debtor will often delay payments to its creditors. As a result, the transfers that are the subject of a preference action are usually those that pay invoices much later than in the prior course of dealings between the debtor and creditor. Under some circumstances, however, the debtor may pay its creditor sooner than it did in the prior course. This is the situation in the recent case of *In re TWA, Inc. v. World Aviation Supply, Inc*. In *TWA*, the Delaware bankruptcy court decides the issue of weather an invoice paid within credit terms is conclusively presumed to be within the ordinary course of business between the parties.

In *TWA*, the creditor sold goods to the debtor on credit terms of net thirty days. Prior to the preference period, the parties completed seven transactions over a period of less than two years. Of the seven invoices paid by the debtor during the prior course of dealings, none of the invoices was paid within invoice terms. Instead, the invoices were paid in the range of 23 to 158 days after their due date and an average of 69 days late. In contrast, the alleged preferential transfer paid one invoice within the 30-day credit terms.

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THE FACT ACT'S DOCUMENT DISPOSAL RULE: WHAT IT MEANS TO THE CREDIT PROFESSIONAL AND CONSUMER

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The Fair and Accurate Credit Transaction Act of 2003, or commonly referred to as the Fact Act, amended the Fair Credit Reporting Act. The Fact Act was signed into law by President George W. Bush on December 4, 2003.

The Fact Act is primarily aimed at providing consumers with more options to protect and monitor their credit. The Fact Act spills over to businesses obtaining, storing, using and now disposing of consumer credit reports. We shall scrutinize how the recently effective disposal rule of the Fact Act impacts individuals and businesses.

Overview of the Fact Act

The Fact Act was passed because consumer reporting agencies have assumed a vital role in assembling and evaluating consumer credit information. Congress recognized a need to make sure that consumer reporting agencies exercise their responsibilities with fairness, impartiality, and respect a consumer's right to privacy by safeguarding private financial information. The Fact Act is available at www.ftc.gov/os/2004/11/041118disposalfn.pdf.

The Disposal Rule is one of several new requirements intended to combat consumer fraud and identity theft and protect privacy. Proper destruction of confidential consumer data makes good economic sense for both consumers and businesses. In a study released by the FTC, nearly 10 million Americans were the victims of identity theft in 2002 alone. The study also found that United States businesses lost $47 billion and consumers lost approximately $5 billion as a result of identity theft during 2002.

The Fact Act's Document Disposal Rule

The Fact Act's disposal rule is one of the key provisions in the Fact Act. As of June 1, 2005, businesses and individuals must be in compliance by both adopting and implementing their own document destruction policy or contract with an approved document destruction company.

1. What Are Consumer Reports and Other Key Terms

Before scrutinizing the Fact Act's disposal rule there are a few key terms which must be defined. First, the disposal rule applies to consumer reports or the sensitive information derived from consumer reports; but what are "Consumer Reports?"

The Fact Act defines a Consumer Report as information obtained from a consumer reporting company that is used or expected to be used in establishing a consumer's eligibility for credit, employment or insurance. Consumer Reports include credit reports, credit scores, asset searches, check writing history, residential or tenant history and even medical history. The Disposal Rule attempts to protect information on the Consumer Report such as social security numbers, birth dates, addresses, and phone numbers.

Another term which must be defined is disposal. The FTC defines disposal as the discarding or abandonment of Consumer Reports, and the sale, donation or transfer of any medium including computer equip-

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F R O M T H E P U B L I S H E R :

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Guest Column

UNSECURED TRADE CREDITORS COMMITTEE: TO SERVE OR NOT TO SERVE? THAT IS THE QUESTION!

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Under the current Bankruptcy Reform Act of 1994, amended in 1995, a credit executive's decision of whether or not to serve on a court appointed unsecured creditor's committee has usually been based on the dollar value of their employer's claim against a bankrupt customer. Did the dollar value of their claim justify the time and expense of serving on the committee? As a credit executive who has served on more than a dozen such committees, chairing half of them, I can state that little, if any concern has been given to the confidentiality of the activities of an unsecured trade creditors committee. Committee members have been fairly certain that they operated under an umbrella of confidentiality provided by § 1102 of the current Bankruptcy Act.

With assistance from their counsel, unsecured trade creditors committees have engaged the services of professionals such as CPAs, attorneys, negotiated with trade unions, taxing authorities, initiated adversary preference actions and conducted other activities to preserve the integrity of the bankruptcy estate and to aid in the approval of a plan of reorganization. Their activities, meeting minutes, telecommunications and written correspondence have all enjoyed a reasonable degree of confidentiality.

However, under 11 U.S.C.A. § 1102 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which becomes effective on October 16, 2005, such confidentiality may become a thing of the past. Bankruptcy attorneys across the country are expressing concern that revised § 1002 will open the activities of unsecured trade creditors committees to the debtor and outside parties. Credit executives as well, are expressing serious concerns about serving on an unsecured trade creditors committee under revised § 1102 and the potential liabilities to which they as individuals and/or their respective employers may be subjected.

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CHECK 21, NSF CHECKS AND FLASH REPORTS: A NEW ERA IN PROTECTING INDUSTRY GROUP MEMBERS FROM FRAUD?

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Industry credit groups have served vendors needs for reliable credit information for decades. Indeed, the U.S. Supreme Court has recognized that industry group members may exchange credit experience information. Many industry credit groups also serve their members by providing them with alerts or "flash reports" when a member receives notice of an NSF check. These flash reports are used by industry groups to alert members that there may be a risk of even accepting payment by check from a customer, of being ensnared of a bust out given that a member has not been paid.

Flash reports, however, have not realized their potential as an early warning system for the vendor who is the target of a bust-out or fraudulent transaction. The reason is that the member is not promptly notified that the customer's check has not cleared, which means that the vendor cannot promptly notify the industry group leader of the bounced check. Often a vendor must wait several days before receiving notice of the bounced check, especially with an out-of-state checks. That delay by the bank in notifying of the bounced check provides the bust-out artist with the window for which they may load up on inventory from other vendors.

On October 28, 2004, the Check Clearing for the 21st Century (Check 21 Act), federal legislation affecting all states, went into effect. Check 21 changes the method that checks are processed in the United States, as well as changes the technology of check payment and acceptance. With Check 21, financial institutions may process checks electronically, instead of transporting the paper checks. With checks being processed electronically, they are expected to clear in hours, not days. Indeed, a vendor may be promptly notified by the bank of an NSF check, even with an out-of-state check. May the arrival of Check 21 make flash reports an effective "red flag" and allow the vendor from being ensnared in the bust-out or fraud? bad check laws? What steps does a vendor take to enforce the bad check in light of Check 21?

Overview of Check 21

Approximately 75 percent of trade credit transactions are conducted by check. Check 21 focuses on the delay caused by a paper check being transported through the banking system.

Check 21 permits the depository bank, if it so chooses, to "truncate" the original check. Truncating a check means to take the check out of physical circulation by transforming it using a computer scanner into a digital image, also known as a substitute check. This digital image becomes the legal equivalent of the original check, provided it meets the criteria set out in the legislation. Truncating the check permits banks to process the digital image for payment in hours rather than days. As a result of image technology, delays attributable to weather or air travel are gone.

Fraud and Bust-Outs In Action

A bust-out is a scheme devised to defraud vendors of their merchandise through the use of planned bankruptcies and business failures. Bust-out schemes are usually orchestrated in two stages. The first stage may be characterized as laying the groundwork for the bust-out and the second stage as execution.

In the first stage, the usual practice of bust-out operators is to create a fake corporation and establish a payment historycredit account with severalone or more vendors. With, make small purchase orders, and pay within invoice terms on the multiple trade historylimited credit provided. In this way, the bust-out operator establishes good credit (i.e., credibility) with vendors. Bust-out operators have found that having a Fortune 500 company as a reference can go a long way towards avoiding thorough credit checks.

Vendors become unwitting participants to a bust-out when they do not conduct thorough credit checks of new customers. A vendor's resources to do so often limited, while increasing competition in many fields has pushed large numbers of vendors to relax their credit standards. Unsuspecting

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YOU DID NOT MAKE THE CRITICAL VENDOR LIST OR THE CRITICAL VENDOR MOTION IS DENIED; NOW WHAT WITH FUTURE SALES?

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The credit professional well knows that a customer's Chapter 11 means long delays before receiving any payment on the prepetition account, which payment is usually but a fraction of the claim. Indeed, it is not uncommon for the vendor to receive stock in the reorganized debtor in exchange for its prepetion claim. Traditionally, the vendor would file a proof of claim, perhaps serve on the creditors' committee, and press for a meaningful payment. Does a vendor in this situation, especially one with substantial trade relationship, have any recourse? With the development of the critical vendor doctrine, the vendor deemed critical has had a meaningful alternative.

The critical vendor doctrine permits a debtor to select certain vendors it deems as indispensable for its ongoing operations. In this situation, the debtor will pay the vendor's prepetition claim in the opening days of the case in exchange for the vendor's commitment to extend credit postpetition. However, the critical vendor doctrine has come under criticism from some creditors and courts, especially since the Kmart ruling. With the increased criticism comes increased creditor and court scrutiny of a debtor's critical vendor motion. What are a vendor's alternatives where a debtor's critical vendor motion is not approved by the bankruptcy court, or the motion is approved but the debtor does not to select the vendor as critical? Are there still opportunities to have the prepetition claim paid? What of postpetition credit risk?

A. The Critical Vendor Doctrine

To be classed as "critical" by a Chapter 11 customer is usually an extraordinary result for the vendor as it means payment in full or a substantial portion or the prepetition claim, given the alternative of waiting, perhaps for years but for a fraction of the prepetition claim. However, a Chapter 11 debtor's funds available for the critical ven-

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SUPPLIERS MUST WATCH THE CLOCK IN PURSUING PACA CLAIMS AGAINST OWNERS OF BUSINESS

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Can a supplier of perishable goods, such as fruits and vegetables, get a priming lien on the goods sold, senior in priority to the financing of the customer's bank, until such supplier is paid in full? Can a owner of the debtor's corporation be personally liable when the supplier is not paid? In other words, does the supplier have a second pocket for payment, even without a personal guarantee? If the supplier indeed has a second pocket, when must the supplier pursue its claims against the owner?

Suppliers of perishable fruits and vegetables should be aware of the provisions of the Perishable Agricultural Commodities Act ("PACA"). As discussed below, PACA addresses these issues and what suppliers have to do to preserve PACA protections, when payments must be tendered and what conduct of the supplier that causes a waiver of PACA protections. In a recent Third Circuit Court of Appeals decision, Weis-Buy Sevices, Inc. v. Paglia (*"Weis-Buy")* , the court considered whether an owner of a corporation should be personally liable to a PACA supplier where the corporation had insufficient assets to pay the PACA suppliers' claims, and when a PACA supplier must bring such an action.

Purpose of PACA

In 1930, Congress enacted PACA to provide protections to suppliers of perishable agricultural commodities in cases where a buyer failed to make payment as provided by contract. Congress believed that ordinary state court collection lawsuits, such as suits for recovery of damages, did not adequately protect suppliers of perishable goods. Congress found that certain financing arrangements between dealers and brokers deprived suppliers of payment and disserved the public interest. The PACA amendments were designed to provide suppliers with a self-help tool that would enable them to protect themselves against abnormal risk of losses resulting from the slow-pay and no-pay practices by buyers or receivers of fruits and vegetables.

Legal Trust Over Goods, Accounts Receivable and Proceeds

Congress enacted PACA to deter unfair business practices and promote financial responsibility in the perishable agricultural goods market. One of the primary purposes of the act was to protect the suppliers of perishable agricultural products as they must entrust their products to a merchant miles away and depend on their good faith and fair dealing for their payment. In addition, the suppliers have more at stake due to the fact that they generally have capital tied up in land and machinery and the survival of their business depends on timely payment by the merchants whom they make deals with.

While many merchants operate on bank loans which are often secured by the merchant's inventory and proceeds of sale of perishable commodities making the bank a secured creditor, suppliers of fresh fruit and vegetables on the other hand are unsecured creditors and receive little protection in any suit for recovery of damages where the merchant neglects to pay as required by contract. Thus, this legislation would provide a remedy by impressing a floating trust in favor of the unpaid supplier on the inventories of commodities and products resulting from those transactions and on the proceeds of sale of such commodities. On the one hand, the trust provision gives assurance that the raw products will be paid for promptly, while on the other hand, the monitoring system provided under the act will protect the interest of the borrower.

PACA in Action

In the *Weis-Buy* ruling, suppliers of fruit made several shipments on credit to a produce corporation. The corporate debtor failed to pay, and filed bankruptcy. The bankruptcy court found the suppliers' claims were valid PACA claims, and, therefore, each supplier received a partial distribution from the corporate debtor's assets. The suppliers filed suit in state court against the debtor's owner seeking to recover the remainder of the money owed. The suppliers alleged that the debtor's owner breached his fiduciary owned to the suppliers under PACA. The state court found the owner liable and ordered judgment in favor of the suppliers for the remainder of their outstanding balance, interest and attorney's fees.

The owner appealed, contending the suppliers' suit should have been dismissed as the collection action was timed-barred. The owner complained that the suppliers should have filed their collection suit against him long ago.

Individual Liability to Suppliers

On appeal, whether an individual corporate officer or owner of a corporation or LLC can be held personally liable to suppliers for breaching his fiduciary duty to protect PACA trust assets was a matter of first impression with the appellate court.

In considering sister circuit court decisions, the appellate court noted several courts had concluded that individual liability did exist in certain circumstances. The Ninth Circuit Court, for example, found that officers and shareholders who control PACA trust assets, and who breach their fiduciary duty to preserve those assets, may be personally liable.

The concept of individual liability, even though the buyer of the produce is a corporation, is derived from the common law breach of trust principle. Under common law, a trustee owes a fiduciary duty to the trust in administrating the trust to exercise such care as an ordinary prudent man would exercise in his own dealing. This type of liability is distinct from the liability arising when the corporate veil is pierced and the corporate form is disregarded because the individual uses the corporation as only a shell to advance their own personal, rather than corporate ends. Rather, under trust principles, breach of one's fiduciary duty as an administrator is considered a tortious act, one that can lead to individual liability. Therefore, individual shareholders or officers of a corporation can be held individually liable in certain circumstances for breaching their fiduciary duty.

When the Supplier Must Pursue the Owner

The appellate court held that the suppliers' claim against the owner was tolled until the date of the bankruptcy court's decision authorizing partial payment to PACA claimants from the debtor's assets. The court noted that under the PACA statute, a supplier had two years from the date the claim accrues.

Generally, the statue of limitation begins to accrue as soon as the trustee breaches his or her fiduciary duty. The owner here argued that the statute of limitation should have commenced as of the date

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The bank need not look past the documents to examine the underlying sale of goods.

Thus, a creditor is given protections that the issuing bank must honor its demand for payment (which complies with the terms of the L/C), regardless of whether the goods conform to the underlying sale contract. The amount of the L/C should equal the amount of the line of credit.

The L/C's independence of contracts allows a creditor to avoid the impact of a customer's bankruptcy, as a general rule. The creditor is paid by the bank and does not wait until the debtor confirms its plan. Bankruptcy courts recognize that the proceeds of a letter of credit are not property of the customer's bankruptcy estate, and that a bankruptcy court generally does not have authority to bar payment under a L/C, notwithstanding the effects of the automatic stay.

2. Certificate of Deposit

A CD may be issued by the customer's bank in the name of the creditor, or the creditor may hold a customer's deposit to reduce the risk of nonpayment with the credit sale. The CD is unconditionally payable to the creditor upon demand, and automatically renews for the length of the credit line. The principal amount accrues to the benefit of the creditor, and interest is paid to the customer. The creditor should have a written agreement with the customer that states this deposit arrangement.

The CD should be entrusted to the creditor and thus not part of the bankruptcy estate. A creditor would likely need to obtain relief from the automatic stay from the bankruptcy court to draw down on the CD upon a bankruptcy filing.

3. Credit Insurance

A creditor purchases credit insurance (CI) to avoid loss on a speculative customer, but retains the accounts receivable. CI may cover a variety of credit risk, such as a customer's bankruptcy, a default or dispute. An example of the terms of a credit insurance policy might stipulate that the CI generally covers up to 90% of the insured account. The risk premium for CI may be measured by the creditor's accounts receivable risk profile. The credit insurer may monitor the buyer's financial condition. The term of the policy may be one year.

The CI contract is not affected by a customer's bankruptcy. Bankruptcy courts recognize that the proceeds of a CI policy are not property of the customer's bankruptcy estate, and that a bankruptcy court does not have authority to interfere with payment under a CI policy.

A creditor does not have to obtain relief from the automatic stay from the bankruptcy court to receive payment on the CI policy after the bankruptcy filing.

4. Factoring

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

Factoring is an independent agreement between the supplier and the factor, and allows a supplier to avoid the effects of a customer's bankruptcy. Depending on whether the factoring agreement is recourse, it may be the factor that is the party in interest in the bankruptcy.

Bankruptcy courts recognize that the factor's payment of a supplier's claim is not property of the customer's bankruptcy estate, and that a bankruptcy court does not have authority to interfere with payment, notwithstanding the effects of the automatic stay.

5. Guarantee

A guarantee, whether corporate or personal, is not the preferred credit enhancement, as it requires the creditor to take legal action to get paid when the customer fails to pay. However, a guarantee may be used as leverage by the creditor to force the customer to pay by threatening to pursue the guarantor, who may be a principal of the customer. The basic legal principle is that the guarantor is not a party to the principal debt. The guarantor's undertaking is independent of the customer's promise to pay.

Merely because both contracts are on the same paper, for example, the credit application -- the customer's promise to pay for the creditor's goods or services, and the guarantor's promise to pay if the customer does not -- does not change the independence of the agreements.

The guarantee should be signed before a notary to reduce the risk that the guarantor may contend that the guarantee was forged. The guarantee's independence of contracts may allow a creditor to avoid the effects of a customer's bankruptcy.

6. Purchase Money Security Interest

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

The creditor's PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the customer receives possession of the goods; and (2) the creditor gives written notice to any other preexisting inventory secured creditor. If the creditor fails to perfect the PMSI, including giving notice, the creditor's priority is governed by the "first to file" rule. This means that an inventory secured creditor will prime the creditor's PMSI.

The creditor holding a PMSI should be entitled to adequate protection with the customer filing bankruptcy. Adequate protection provides that the creditor's property interest is entitled to protection from depreciation and is insured against risk of loss.

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7. Consignment

Article 9 of the UCC's perfection requirements provides the means whereby a supplier can establish a valid security interest in its own inventory, even when that inventory has been delivered to the customer. The supplier's compliance with the perfection requirements of the UCC protects ownership of inventory. In the event of a dispute over the goods, the supplier will prevail over a competing supplier.

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

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

With the bankruptcy filing, the creditor that is a party to a consignment agreement with the debtor may find the agreement challenged by a debtor or other party if the creditor fails to adhere with Article 9. The creditor may also have to trace the proceeds the sale of its product that is subject to the purchase money security interest.

8. Security Interest in Assets

Where the creditor has a delinquent account, the creditor may be able to obtain collateral from the customer to secure its delinquent account in the form of a Security Agreement. The Security Agreement between the creditor and customer generally covers all property of the customer concerning the creditor's pre-existing debt. The creditor's priority to the customer's assets is generally chronological to preexisting secured creditors (first to file), and does not require notification to prior secured creditors, as the creditor's interest is junior to theirs.

The creditor's lien on all the debtor's assets is perfected at the time of filing the UCC-1. The debtor's assets include all things that are movable, but do not include money or general intangibles. The debtor must sign the security agreement and the security agreement must describe the collateral. The requirements for the creditor that must be met in the creation of a security interest are that: value must have been given by the creditor in exchange for the security interest; the debtor must have rights in the collateral it offers; and the debtor must have signed a security agreement which contains a description of the collateral. A creditor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) that adequately describes the collateral.

The main purpose in filing a financing statement is to guarantee that any third parties will have been notified of existing security interests in the collateral. The filing creditor thus takes priority over other non-secured creditors and has the right to take possession of and sell the collateral if the debtor defaults. The creditor holding a secured claim in the debtor's assets should be entitled to adequate protection with the customer filing bankruptcy.

9. Setoff

The right of setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the situation of making A pay B when B owes A. The right of setoff arises under state law and, if such right exists, is preserved in bankruptcy cases. For a company to offset, three steps must be taken: (1) an authorized officer must make the decision to effectuate the setoff, (2) some action must be taken accomplishing the setoff and (3) the setoff must be recorded.

Offsets allow entities that owe each other money to setoff the debts against one another. The filing of bankruptcy by a debtor dramatically changes the economics of an open account relationship involving the setoff of mutual debts. It is vitally important to preserve the right to setoff debts in the context of bankruptcy.

If the creditor cannot obtain a credit enhancement from the customer, the creditor may consider an alternative means of payment to reduce credit risk.

10. Credit Card

Having a customer pay by credit card is appealing to the seller as it allows for payment prior to goods being released to the customer. However, a seller may be at risk with the customer charging a purchase. The creditor may be responsible for unauthorized purchases and fraud. A seller may accept a personal credit card for a commercial sale; however, it may be an indication that the company the person is purchasing for is in financial trouble. (More likely, it means that the person wants the frequent flyer miles).

Credit card transactions conducted by telephone, fax or the Internet, also known as card-not-present transactions, have a higher risk of fraud. A credit card payment is an independent agreement, and allows a creditor to avoid the effects of a customer's bankruptcy.

11. E-Checks and Checks by Fax

An e-check is an electronic version of a paper check. The e-check may provide for multiple payers, endorser signatures and is governed by the UCC covering checks. The creditor may choose to have a third party accept the payments in an elockbox or have the receipt directed to the accounts receivable department for handling. E-checks use digital signatures where federal legislation recently recognized their use.

Checks by Fax are similar to conventional checks with the difference being that you print your customer's check on your in-house printer or fax machine and prepare it for deposit. Your customer makes out a check payable to you, signs it, just as if it was to be mailed, and faxes it to you. You then make a bank draft "duplicate" of the check and submit it for deposit, and keep their original check as a record of this trans-

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THE FACT ACT'S DOCUMENT DISPOSAL RULE: WHAT IT MEANS TO THE CREDIT PROFESSIONAL AND CONSUMER

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ment on which Consumer Reports are stored.

2. Who Must Comply With The Disposal Rule

The Disposal Rule applies to the government, individuals, large and small organizations; basically any person or entity which uses a Consumer Report. Entities which use Consumer Report for example are consumer reporting companies, lawyers, mortgage brokers, landlords, government agencies, car dealers, private investigators, credit card companies, banks and debt collectors. The FTC recommends that those who use any records containing a consumer's personal or financial information to take similar protective measures.

3. Requirements and Procedures

The Disposal Rule requires disposal methods that are designed to prevent the unauthorized access to the information contained in the Consumer Report. The Disposal Rule's standards for the proper disposal of Consumer Reports are flexible. This allows for individuals and organizations to determine the most cost effective manner in which to dispose of the Consumer Reports. The Disposal Rule applies to electronic data storage devices as well.

Options for the disposal of Consumer Reports include burning, redacting, pulverizing and shredding. The FTC recommends those who shred documents use shredders which result in chips, and not strips. Traditional strip shredders create 15 pieces that can be reassembled. While it is time consuming to find each strip and then put the document back together again, it does happen. Traditional strip shredders may not be a method which prevents the unauthorized access to information contained on the Consumer Report.

If an individual or entity hires a document disposal company, they must obtain references for the disposal company, proper certification from a trade association and conduct an independent audit of the disposal companies operations.

4. Penalties for Violation of the Disposal Rule

The FTC and state attorney generals may sue and win penalties for violating the Disposal Rule including actual damages, statutory damages up to $1,000 punitive damages per violation, attorney's fees, and civil penalties up to $2,500.

What Does the Disposal Rule Mean to Credit Professionals

Credit professionals evaluating whether to sell goods on credit to sole proprietors, partnerships and limited liability companies usually obtain the personal credit and asset reports of the individual owners of these entities. These reports are Consumer Reports; as of June 1, 2005, the disposal of these Consumer Reports is governed by the Fact Act's Disposal Rule. Credit Professionals must implement a disposal plan which ensures the information contained in the Consumer Reports is destroyed properly.

Conclusion

The Fact Act's Disposal Rule not only makes good economic sense for both consumers and businesses, but it will help to combat the growing crime of identity theft. No individual or company desires to be the source of another's personal information falling into the wrong hands. Identity theft costs all of us money in the long run. Hopefully the Fact Act's Disposal Rule will close a long used avenue for unscrupulous individuals to obtain the private information of consumers.

BANKRUPTCY REFORM ACT TAKING EFFECT SOON

AS OCTOBER 17 NEARS, CONSIDER CREDIT ENHANCEMENT TO REDUCE BANKRUPTCY RISK

(***Continued from page 6***)

action. Previously technology was an issue for some smaller local banks, but those issues for the most part have been resolved. Provided that the customer's e-check or fax check has cleared its account, there should be no bankruptcy risk with a customer paying by that method.

Conclusion

Credit enhancements or alternative payment mechanisms can make the sale and reduce the risk prior to the Reform Act's effective date of October 17. The key to a credit enhancement is to structure the instrument so that you will realize the maximum recovery upon a customer's bankruptcy.

CHECK 21, NSF CHECKS AND FLASH REPORTS: A NEW ERA IN PROTECTING INDUSTRY GROUP MEMBERS FROM FRAUD?

(Continued from page 3)

companies of any size, including Fortune 500 companies, are vulnerable to bust-out schemes.

Some large companies have sophisticated credit departments, yet even some of these become lax when an order involves five-digit or six-digit amounts. The bust-out operator takes possession of the goods, then sells it at a steep discount -- often to legitimate businesses. The cash from the sale is used to pay for prior orders, until it is time to execute the bust-out.

In the second stage of the bust-out, the execution, the operator places large orders on open account with as many vendors as possible. Where the vendor demands payment by check from the customer at the time they release the goods, the bust-out operator is counting on the float time to load up on inventory from other vendors. Once the vendor receives notice of the NSF check and reports this to the industry group leader, the bust-out operator has already obtained the inventory from other vendors.

The bust-out operator then sells the goods at steepbig discounts in return for immediate cash, and files for bankruptcy liquidation or merely disappears. Far from being experienced businessmen who have stepped over the line in their business decisions, bustbut-out operators are usually members of criminal rings that operate for the sole purpose of defrauding vendors.

Check 21 and NSF Checks

Notification of NSF checks may change significantly post-Check 21. Post-Check 21, a vendor may learn promptly of an NSF check because the float time is less and most banks will offer notice of NSF checks via email or on-line. Each bank may set up its standard for immediately notifying vendors of bounced checks.

At this point, it appears that banks may set their own standards for the redeposit procedure, after the initial attempt fails. The bank may redeposit the check without returning the check to you, based on your instructions to them. Or, the bank may issue a substitute check stamped "Returned due to NSF" and return the check to you. The substitute check is the legal equivalent of the original, so you may use this for reporting to the police authorities.

Flash Reports

NACM/Chicago-Midwest flash-reporting services, over the last two years has evolved meet the needs of today's savvy credit professional even more efficiently. Web access now allows critical account information to be delivered via our secure site and distributed as an alert to industry credit group members within 24 hours. Once submitted, the information is transmitted to NACM/Chicago-Midwest where it is screed by trained personnel ensuring confidentiality and compliance for Antitrust. Only then is it distributed to participating group members in an email. This enhancement gives credit managers a valuable resource with which to base their credit decisions on more real-time information. Further, this information is reflected both regular flash reporting cycles as well as on the group's credit exchange report so it can be used as a reference and a benchmarking tool.

NSF Checks and Flash Reports

An industry group's flash report of a member's notice of an NSF check will have even greater value to industry group members with Check 21. As a vendor will be promptly notified that a check has not cleared, that vendor will notify the industry group leader who may immediately send out a flash report. Given that the vendor is learning of the NSF check much earlier, especially with out-of-state checks, the flash report may become more valuable by assisting vendors in deciding what action to take with their pending orders.

A common way for an unscrupulous businessperson to take advantage of a vendor is a bust-out scheme. A bust-out scheme is devised to defraud vendors of their merchandise through the use of planned bankruptcies and business failures. Bust-out schemes are usually orchestrated in two stages.

In the first stage, the usual practice of bust-out operators is to create a fake corporation, establish a credit account with one or more vendors, place small purchases, and pay within invoice terms on the limited credit provided. In this way, the bust-out operator establishes good credit (i.e., credit worthiness) with vendors.

In the second stage of the bust-out, the execution, the operator places large orders on open account with as many suppliers as possible. He or she then sells the merchandise at steep discounts in return for cash, and often merely disappears. Traditionally the best way for credit executives to avoid a bust-out scheme was conducting a thorough investigation of the company. Check 21 will substantially thwart efforts of unscrupulous businesspersons.

With Check 21, suppliers may be able to confirm whether the check is good prior to releasing the shipment, or while the goods are in transit. With Check 21, the credit professional may find receiving a check akin to a customer paying by credit card. While a payment by check will not result in a simultaneous transfer of funds, with Check 21 it may allow the supplier to avoid being ensnared in a bust out.

There are several steps credit executives can take to protect themselves. These steps include: keep the vendor's credit functions and sales functions separate; visit the new customer during business hours and observe sales behavior; visit the customer when the business is closed; ask for a personal guarantee; and discuss the account with other vendors in the industry group.

Check 21 and Flash Reports Help the Vendor

When the business failure includes a bankruptcy filing, a vendor's legal remedies are also limited. The vendor may be able to convince the bankruptcy trustee of the failed business to pursue the buyers of the discounted merchandise under a fraudulent conveyance theory. The trustee would, however, need funding to pursue such litigation. A vendor may attempt to block the discharge of its claim in the bankruptcy by filing a complaint to determine the dischargability of its debt where the operator has filed an individual bankruptcy. In either situation, the vendor still faces the problem of locating the operator's assets.

Flash reports will become more effective as a result of Check 21, given that the vendor will be promptly notified of the NSF check, even with the out-of-state check. Provided that the vendor immediately noti-

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YOU DID NOT MAKE THE CRITICAL VENDOR LIST OR THE CRITICAL VENDOR MOTION IS DENIED; NOW WHAT WITH FUTURE SALES?

(Continued from page 3)

dor class is limited, as well as scrutinized (and perhaps objected to) by lenders, bondholders, noteholders, a creditors' committee, the U.S. Trustee's office, and even competing vendors who want to be elevated to critical vendor status.

With some of the largest public companies filing Chapter 11, critical vendor motions are more common -— and more scrutinized than ever. Since the Seventh Circuit Court of Appeals ruled in Kmart of a more exacting standard, bankruptcy judges are now often insisting on detailed support to pay a vendor immediately on the prepetition claim. The judges are also granting immediate relief on an interim basis in order to give other parties involved, such as a creditor's committee, time to review the request.

The critical vendor doctrine may be viewed as conflicting with a fundamental principle of bankruptcy which is equal treatment (e.g. payment) for the same class of unsecured creditors' claims. In bankruptcy, the general rule is that vendors may be paid on their unsecured claims only through a confirmed plan of reorganization or court-authorized liquidation.

The payment of claims deemed critical is to induce vendors to continue supplying key goods and services post-bankruptcy on credit, which may enable a debtor to continue to operate and, perhaps, exit bankruptcy. In exchange for the vendor being paid in full, the debtor conditions the vendor extending comparable credit terms postpetition. The critical vendor agreement is reflected in a letter agreement between the debtor and the vendor. The agreement also provides for a "claw back" provision that permits the debtor to recapture the critical vendor payment if the vendor refuses to continue to extend credit.

B. Critical Vendor Alternatives

Given the increased scrutiny that a critical vendor motion is now subject to, what alternatives are available to a vendor in considering making a sale to a Chapter 11 debtor.

1. Payment of All Vendors' Claims Through Prepack

If a debtor is contemplating Chapter 11, it may negotiate with its major creditor constituiencies, such as bondholders and noteholders, with hopes to reach agreement as to their treatment under a plan of reorganization. These pre-bankruptcy negotiations may result in a consensus not only as to bondholders and noteholders, but vendors as well. For example, in the Trump Hotels bankruptcy, a prepackaged plan was filed that proposed to pay all vendors prepetition claims in full. The debtor did not wait to pay vendors until the plan of reorganization was confirmed, but obtained court approval to pay all of the vendors claims shortly after the Chapter 11 filing. From the vendors' view, this may be viewed as a "super critical" vendor motion, given that all vendors' prepetition claims were to be paid. As the plan of reorganization had been prearranged, the court approved the early payment of all of the vendors, without the debtor going through the rigors of meeting the critical vendor elements.

2. Selling on Credit Postpetition

To encourage vendors to sell a debtor on credit postpetition, the Bankruptcy Code provides that should the debtor default on the credit sale, the vendor is entitled to an administrative claim for the unpaid balance. Unlike the critical vendor doctrine, a postpetition credit sale does not allow for payment on the prepetition claim. The vendor should be mindful that while the Bankruptcy Code provides for priority status for unpaid postpetition invoices, a vendor holding a priority claim is not guaranteed payment. Rather, a debtor could find itself administratively insolvent. In this situation, the vendor's priority claim could go unpaid.

a. The Catch Up Issue

If the vendor does not qualify as a critical vendor, the vendor may resolve to find an alternative to have its prepetition claim paid. A general principle of the Bankruptcy Code is that a vendor may not be paid on its prepetition claim postbankruptcy, absent a court order or a confirmed Chapter 11 plan. However, a vendor may attempt to have the debtor pay down its prepetition debt by inflating its postpetition invoices. This "catch up" scheme may be illegal, and can result in disgorgement of the inflated invoices and, possibly, criminal action.

3. Junior Lien Sales

Those vendors that do not qualify as critical, a debtor may offer vendors a junior lien on assets in exchange for selling on credit. The purpose of the junior lien is to reduce the risk that if the debtor fails to pay for the credit sale, the vendor may have some assets to look to for payment. However, the junior lien sale does not pay a vendor's prepetition claim.

4. Sale of Claim

A vendor that is not selected as critical, may elect to sell its prepetition claim. Third parties, unrelated to the debtor, offer to purchase a trade creditor's prepetition claim, at a discount. Unlike the critical vendor doctrine, a vendor does not have a continuing obligation to sell the debtor on credit when it sells its claim to a third party. Also, unlike the traditional critical vendor doctrine, a vendor selling their claim does so usually at a steep discount.

C. Consider the Alternatives When Selling to a Chapter 11 Debtor

Those vendor that have been deemed critical are rewarded with immediate payment on their prepetition claim, as well as continued sales (salesperson is happy}. If not deemed critical, the vendor may still have an opportunity to make the sale to a Chapter 11, perhaps even with collateral supporting the sale.

SUPPLIERS MUST WATCH THE CLOCK IN PURSUING PACA CLAIMS AGAINST OWNERS OF BUSINESS

(Continued from page 4)

the supplier's invoices became due. The appellate court overruled that argument and found that debtor's failure to pay invoices was a continuing violation. Under the continuing violation doctrine, the focus was on the wrongful acts of the owner. The appellate court affirmed the lower courts ruling, finding that the owner must pay the PACA claimants. The owner appealed to the circuit court of appeals.

The court of appeals reversed the lower courts' rulings, finding that the suppliers were on notice of owner's breach of fiduciary duty when the debtor first failed to pay its bills, and at the very least was on notice when the debtor filed for bankruptcy protection.

The court of appeals saw no justification for tolling the statute of limitations as they only applied to cases where the defendant had actively misled the plaintiff regarding their cause of action, or where the plaintiff was prevented in some extraordinary way from asserting his right or where the plaintiff had timely asserted their right in the wrong jurisdiction. The court of appeals did not find any of these situations were present here.

The court of appeals reasoned that when the suppliers were initially not timely paid, they were on notice that debtor, and the responsible parties of the debtor, had breached their trustee obligation. This alone should have given the Suppliers an incentive to find out why their payment was delayed or who the cause of the problem was, according to the court of appeals. However, as the suppliers did not take adequate action to discover the cause of the problem or to file a suit, the statute of limitations began as of the date of non-payment and was not tolled.

Here, the suppliers did not file suit until two years after any of their invoices became due and more than two years after the debtor filed bankruptcy. As such, the statute of limitation had run out and the suppliers were barred from pursuing their claims against the owner, the court of appeals ruled.

IS A PAYMENT MADE WITHIN CREDIT TERMS ALWAYS PROTECTED BY THE ORDINARY COURSE OF BUSINESS DEFENSE? - MAYBE UNDER THE BANKRUPTCY REFORM ACT

(Continued from page 1)

In lieu of a trial, the parties submitted a joint trial brief containing stipulated facts and arguments from which the court made its decision. The creditor argued that a payment made within credit terms is conclusively presumed to be within the ordinary course of business. The creditor asserted that the court should not look to the prior course of dealings, but, instead, focus solely on whether the debtor made its payment within the contract terms. The creditor likened its proposition to that of the holdings in many jurisdictions that payments made beyond the payment terms are considered as falling outside the ordinary course of business between the parties and are presumed to be non-ordinary. The court noted, however, that such presumption can be rebutted by an examination of the prior course of dealings, unlike the irrebuttable presumption proffered by the creditor.

In ruling against the creditor, the court found that a payment made within contract terms during the preference period, when the history of dealings between the parties was that of payments being made well outside such terms, is far more likely to be preferential than it is to be ordinary. In ruling against protecting all payments made within credit terms, the court acknowledged that Congress could have easily provided a "bright line" or presumptive rule to protect such transfers, but did not. In the end, the court found that the history of dealings between the parties made it clear that the alleged preferential transfer was not at all consistent with any of the transfers which were made in the prior course of dealings between the parties.

It is important to note the changes to the ordinary course of business under the Bankruptcy Amendment, as the creditor in *TWA* would have likely succeeded under the new laws had they been in effect. Under the new preference laws, the subjective and objective tests are disjunctive, meaning that a creditor must only prove one or the other, but not both as under the current law. Under facts such as those in *TWA*, a creditor could argue that payment within credit terms is ordinary for the industry, in order to satisfy its burden under the ordinary course of business defense (and also demonstrate that the debt was incurred in the ordinary course). Barring extraordinary circumstances, this should be a winning argument under the new laws, but only time will tell.

CHECK 21, NSF CHECKS AND FLASH REPORTS: A NEW ERA IN PROTECTING INDUSTRY GROUP MEMBERS FROM FRAUD?

(Continued from page 8)

fies the industry group leader of the NSF check, the flash report can be that red flag that prompts other industry group members to hold orders and insist on certified funds before releasing the goods.

Even with the arrival of Check 21, credit professionals must be vigilant for red flags indicating a risk of fraud or a bust out. Although Check 21 may allow the industry group leader to promptly send out a flash report that may serve as an early warning of an NSF check, if the goods have been shipped and cannot be reclaimed, the vendor will likely be unable to recover the goods in a fraudulent transaction.

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i. Natalie Wriston is Manager of Group Services for NACM/Chicago-Midwest with a staff responsible for credit reporting services and planning business meetings for over 40 industry credit groups. Her email address is natalie@nacmchicago.org.

Guest Column

UNSECURED TRADE CREDITORS COMMITTEE: TO SERVE OR NOT TO SERVE? THAT IS THE QUESTION!

(Continued from page 2)

It remains to be seen how the courts will interpret revised § 1102 in bankruptcies filed after October 16, 2005. Until remedies have been identified and/or precedent set, credit executives choosing to serve on unsecured trade creditor committees should seek and follow the advice of legal counsel specializing in commercial bankruptcy.

Mr. Dorman Wood is president of Dorman Wood Associates, Inc. and advises creditors as to their preference defenses, including serving as an expert witness in such actions.

His email address is witness4u@msn.com and his website is www.witness4u.com

Blakeley & Blakeley LLP Recent Engagements and Activities for Fall 2005

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

◊ Scott spoke to **NACM Connecticut** members in Denver regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to **NACM Atlanta** members in Seattle regarding **Privacy Rights** and **Check 21**.

◊ Scott spoke on a teleconference with **NACM's** members regarding **Credit Application**.

◊ Scott spoke to **NACM Chicago-Midwest** members in San Francisco regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to the **NACM/Ohio** members in Kansas City regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to the **CFDD** in Kansas City regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to the **Credit Exchange/Aerospace Suppliers Industry Group** in Las Vegas regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to **NACM/Tampa** members in San Diego regarding **Sarbanes Oxley** and **Credit Cards**.

◊ Scott spoke on a teleconference in **"What's Working in Credit"** regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to **NACM/North Central's** members in Huntington Beach regarding the **Bankruptcy Reform Act**.

◊ Scott spoke to the **Southern Nevada Institute of Credit** regarding the **Bankruptcy Reform Act** and **Check 21**.

◊ Scott spoke to **NACM Oregon** members in Portland regarding **Privacy Rights** and **Check 21**.

◊ Scott spoke on a teleconference to **NACM Chicago-Midwest** regarding **Hot Topics for 2005**.

◊ Scott spoke to **NACM/Kansas City** members in Lake Tahoe regarding **Check 21** and the **Patriot Act**.

◊ Scott spoke to **NACM Chicago-Midwest** regarding **What's Hot With Preferences.**

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