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THE TRADE VENDOR QUARTERLY

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

IMMUNIZING PAYMENTS FROM PREFERENCE RISK: THE CREDIT CARD DEFENSE?

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The credit executive is well aware of the skill needed to collect on a delinquent account, yet maintain the trade credit relationship, if management is concerned about possibly losing the customer to a competitor. With new orders, the credit executive's job is to ensure that the debtor pays close to the invoice due date. However, should the customer face a cash crisis, they likely do not have sufficient liquid assets to pay the vendor's invoice. Given this, the credit executive may look to alternative payment methods. The credit executive, in implementing a strategy to collect the delinquent account, may need to balance ways to minimize the risk of a bankruptcy preference suit (or strengthen defenses) should the customer later file bankruptcy within 90 days of receiving payment. Payment by credit card may be the answer. But what of the preference risk, should the vendor receive payment by credit card during the preference period?

The bankruptcy court in *In re Perry*[2] recently considered whether a vendor must disgorge payments as a preference, even though the payment was made by credit card. The court dismissed the preference suit. While the Bankruptcy Reform Act gives greater protection to vendors in challenging a preference suit under the ordinary course of business defense, the vendor still has several hurdles to overcome the preference challenge using the ordinary course of business defense. The goods news for credit executive's with the *Perry* ruling is that the vendor is not required to prove up the common preference defenses, but dismissed the case based on the trustee's failure to prove up the preference elements. The court's ruling and its meaning to vendors is considered.

A. Accepting Payment By Credit Card in B2B Transactions

Not so long ago, a credit executive accepting payment by credit card for a B2B transaction was an aberration. Not so today. Payment by credit cards involving B2B transactions continues to increase, with over $100 billion in payments this year. Vendors, as sellers, accepting payment by credit card consider several advantages to payment by check or other forms of payment, such as: immediate payment and therefore improved cashflow, increased sales, facilitates collections as there is no accounts receivable, reduced administrative costs, minimize documents, improve financial planning and reporting and customer convenience.

B. The Preference Action and Property of the Estate

Should the credit executive receive payment by credit card and the customer

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RETURNED INVENTORY AS A PREFERENCE CLAIM: WHAT IS THE VALUE?

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Preference claims are one of the more frequently litigated issues in bankruptcy, and the typical preference claim is based on a debtor's payment of antecedent debt. However, sometimes a preference claim is based on the debtor's return of inventory to the creditor in return for a reduction of the creditor's claim. The few reported decisions concerning return-of-inventory preference claims have addressed the determination of the value of the inventory returned by applying various methods. The most recent case from the U.S. District Court for the Western District of Virginia in *Active Wear Inc. v. Parkdale Mills Inc.* applies yet another method of valuation, limiting a chapter 11 debtor's recovery on a return-of-inventory preference claim to the amount the debtor would have realized from a liquidation sale of the inventory.

The debtor, Active Wear Inc., turned yarn into cloth and purchased substantial amounts of yarn from Parkdale Mills Inc. During its period of operation, the debtor purchased substantial quantities of yarn on open account from the creditor, Parkdale Mills, Inc. When the debtor ceased operations, it had unused yarn in its possession which it had purchased from the creditor, at which time it owed on its account with the creditor at least $2 million.

When the debtor ceased operating, the creditor sent a reclamation demand to the debtor for recovery of yarn having the value

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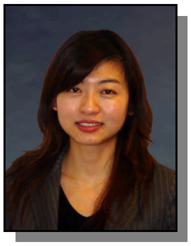
COURT MAY REFUSE ORDINARY COURSE OF BUSINESS DEFENSE BASED ON THE METHOD USED IN APPLYING PAYMENT TO OUTSTANDING INVOICE



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A primary policy underlying section 547(c)(2)(C) of the Bankruptcy Code is to prevent parties from creating unique payment terms that would allow the debtor to manipulate the timing of the payments so that it appears that those payments are consistent with debtor's overall payment history. In *In re Bridge Information Systems*, 331 B.R. 774, the court concluded that the supplier failed to establish its practice of allowing the debtor to direct which payments should apply to which invoices was objectively ordinary within the computer resale industry.

In *Bridge*, the plan administrator for the debtor filed an adversary complaint against the supplier seeking to recover payments that the debtor made to the supplier as preferential transfers. The supplier claimed that the plan administrator may not avoid the payments under the ordinary course of business defense.

The debtor and the supplier entered into an agreement where the supplier agreed to resell computer components parts and systems to the debtor. The terms of the agreement required the debtor to remit payment on each invoice within thirty days of its receipt of the invoice. The agreement also mandated that the debtor remit payment directly to supplier's bank. The agreement also allowed the debtor to match each payment with any outstanding invoice.

During the ninety day preference period the debtor made eight payments to the supplier totaling $2,155,105.80. The plan administrator attempted to avoid these payments as preferential transfers under 11 U.S.C. § 547(b). The parties stipulated that the debtor was insolvent at the time it remitted each of the payments to the supplier. The plan administrator demonstrated that the debtor remitted each of the payments after it had received the computer product and the corresponding invoice, that the debtor made each of the payment during the ninety day preference period, and the debtor made each of the payments to the supplier.

The court stated that the plan administrator must also show that the debtor made each of the payments on account of an antecedent debt as required by 11 U.S.C. § 547(b)(2). The payment summary provided by the supplier's general manger indicated that the debtor remitted payment to the supplier after the thirty day due date for the vast majority of invoices in both the pre-preference and preference period. However, the debtor also made some of the payments before the thirty day due date.

The court reasoned that a debt is incurred on the date upon which the debtor first becomes legally obligated to pay it. A debtor incurred a debt on an obligation once the creditor would have a claim against the debtor's estate if the debtor fails to pay for the goods or services provided. Because the debtor's obligation to pay the creditor arises as soon as it receives the goods or service in question, the debtor incurred a debt when it received the goods or services even if payment was not due until a later date. Since the debtor made the payments after it received the computer components, even if the payments were made prior to the thirty day due date, each of the payments

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FROM THE PUBLISHER:

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Guest Column

U.S. AUTOMOTIVE INDUSTRY: CREDIT EXECUTIVES' LATEST CHALLENGE

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At one time or another, most everyone has seen the video of a long serpentine chain of falling dominos. With this image in mind, picture the falling dominos labeled with the names of the companies within the U. S. automotive industry who have filed bankruptcy within the past year: Tower Automotive, Inc. (2/05); Meridian Automotive Systems Composites Operations, Inc. (4/05); Collins & Aikman Corp. (5/05); Delphi Corp. (10/05); Dana Corp. (3/06), and most recently, Dura Automotive Systems, Inc. (10/06).

How many more "automotive industry" dominos will fall is subject to analysis and speculation by industry experts.

"The shake-out of General Motors and Ford Motor during 2005 has caused the most violent and wide-spread dismantling of the U. S. auto parts supplier sector in the more than century-old history of the automobile. The suppliers sector represents the 'undercarriage' of the auto industry: It produces the brakes, electrical wiring, shocks/struts, seats and other vital components.

The automotive suppliers' collapse reminds us that the auto sector crisis is not months away, but upon us."

"During recent years, the Big Three U. S. automakers Ford, GM and DaimlerChrysler have been under tremendous pressure to reduce costs. Viewed by some within the industry as relentlessness, their cost cutting efforts included plant closures, worker layoffs, and demands on suppliers to reduce prices.

Epitomizing the manner by which the Big Three automakers forced auto suppliers to cut their prices, and thus accelerating the suppliers' collapse, is the case of Troy, MI-based Collins & Aikman, which produces parts for 90% of the vehicles that are built in the United States."

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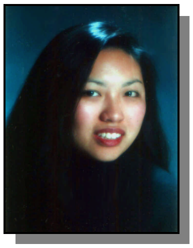
PROTECT THE HELPING HAND: WHEN KEEPING THE DEBTOR AFLOAT TO HELP YOURSELF, DO IT RIGHT



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In In re Spancrete of Florida, Debtor entered into two construction contracts with CORE Construction Services Southeast, Inc. (CORE) to supply and install pre-cast, hollow-core concrete planks at two condominium complexes. After Debtor began experiencing financial problems, CORE assisted Debtor by making payments to Debtor's suppliers and vendors because it was anxious for Debtor to complete its obligations under the construction contracts. CORE believed that the payments to third parties were payments made to Debtor, and the amounts would offset any amounts due and owing to Debtor under the construction contracts. Debtor, on the other hand, believed that the payments were contributions of capital.

Under the arrangement, Employee Professionals would be paid because it handled Debtor's payroll and managed the compensation services for Debtor's employees. If Debtor received an invoice from Employee Professionals that it could not pay, then Debtor would forward the invoice to CORE for payment.

The Debtor forwarded invoices, dated January 14, 21 and 28, 2005, to CORE for payment. CORE paid those Employee Professionals the invoices by wire transfer. On February 1, 2005, Employee Professionals, concerned that Debtor would not be able to make future payments, requested $45,000 be deposited with them for use if Debtor could not pay for services rendered, or if Debtor had an outstanding balance with Employee Professionals when it ceased to operate. Included in its wire transfer payment of the February 4, 2005 invoice, CORE provided the $45,000 deposit that Employee Professionals requested. CORE also wire transferred payment for the February 17, 2005 invoice from Employee Professionals.

Debtor filed its Chapter 11 petition on April 7, 2005. Employee Professionals used the $45,000 deposit to provide funds for two weekly payroll obligations. The first instance required approximately $28,000, and the second required approximately $16,000. Because the deposit was now depleted, Employee Professionals requested Debtor to restore the deposit to the required $45,000 level. As requested, Debtor provided $45,000 to Employee Professionals.

CORE sought a determination that the $45,000 held by Employee Professionals was not a property of the Debtor's estate, therefore allowing CORE to recover the funds and use them to pay amounts due to the Debtor.

Property belonging to a debtor's estate is defined broadly as "all legal or equitable interests of the debtor in property as of the commencement of the case…wherever located and by whomever held." 11 U.S.C. section 541.

The court likened the situation to that of an escrow agreement. After conditions precedent occur, one party is entitled to receive the funds held in trust. Here, the funds were intended to be held in escrow by Employee Professionals and to be used by Employee Professionals to pay any outstanding invoices. The $45,000 deposit provided by CORE was used by Employee Professionals to pay outstanding invoices. Any interest CORE had in the funds held by Employee Professionals disappeared when the initial $45,000 was depleted. The second deposit of $45,000 was provided by the Debtor, and CORE has no cognizable interest in the replenished funds.

How could CORE have protected itself? In T & B Scottdale Contractors, Inc. v. United States, the debtor-subcontractor had a joint bank account with a general contractor. The debtor-subcontractor would submit invoices to the general contractor, who would then deposit enough funds in the account to cover the invoice. The agreement between the general contractor and the debtor-subcontractor specifically stated that account funds were only for paying materialmen. The court held that the deposited funds were held for the benefit of another and therefore were not the property of the estate.

The helping hand gets burned when not adequately protected. Here, it was as simple as inserting a clause in the agreement which stated the financial assistance provided was solely for the purpose of paying suppliers.

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

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The credit executive well knows that a customer's Chapter 11 means long delays before receiving 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 the debtor for a meaningful payment. Does a vendor in this situation, especially one with substantial trade relationship, have any additional alternatives? Fortunately, with the development of the critical vendor doctrine, the credit executive may have an alternative that may result in payment in full.

The critical vendor doctrine most commonly applies where a vendor is a key supplier. Given this key supplier relationship, the vendor often holds a sizeable unsecured claim upon the Chapter 11 filing. The vendor, selling invoice by invoice (as opposed to a long term supply contract), may elect not to continue to sell the debtor postpetiton. However, the vendor's product or service may be viewed by the debtor as essential to its continued operations.

In this situation, the debtor may request that the court authorize it to immediately pay the vendor's prepetition claim, in exchange for the vendor selling to the debtor postpetition on credit. Under the critical vendor doctrine, a vendor may find that the product or service it provides a Chapter 11 debtor is essential to continued operations. The uniqueness of the product or service may give the vendor leverage in negotiating postpetition sales.

Notwithstanding the Seventh Circuit Court of Appeals decision in Kmart, bankruptcy courts continue to consider a debtor's request to treat certain vendors as critical and have their prepetition claims paid in exchange for postpetition trade credit.

For the credit executive considering

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BANKRUPTCY PREFERENCE AND STATE MECHANIC'S LIEN LAWS: IS THE SUBCONTRACTOR PROTECTED FROM THE PREFERENCE

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A fundamental responsibility of a credit executive is assessing a debtor's credit risk. For credit executives employed by subcontractors and material suppliers, states have created special protections to these vendors to reduce or eliminate credit risk through mechanic lien laws. However, what is the effect of the state lien laws where the general contractor files bankruptcy? Are payments made to the subcontractor and materialman during the preference period recoverable by a bankruptcy trustee, or do the states' lien laws protect the vendors from the preference risk? A recent bankruptcy case which considered the interplay of the state lien law and federal Bankruptcy Code's preference provision is considered.

The Bankruptcy Preference

The Bankruptcy Code vests the debtor (or trustee if one is appointed) with far-reaching powers to recover payments to vendors within 90 days of the bankruptcy filing. The power to avoid preferential transfers is one of the most powerful weapons a trustee has. The bankruptcy preference is part of the Bankruptcy Code, which is a federal law that applies to all states uniformly. The purpose of the preference provision is two-fold.

First, unsecured creditors (or undersecured creditors, e.g. those creditors whose collateral is valued at less than their debt) are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period are avoidable. To protect those transactions which replace value to the bankruptcy estate previously transferred, the Bankruptcy Code carves out seven exceptions or defenses to the trustee's recovery powers. The most commonly asserted exception by vendors is the contemporaneous exchange defense, the subsequent advance defense, and the ordinary course of business defense.

Mechanic's Liens

State mechanic's lien laws ensure payment to vendors extending credit for supplying labor and materials that improve property, by allowing the vendors to look to the owner of the property for payment. Many states provide for a payment bond in lieu of a mechanics lien.

The subcontractor must give preliminary notices to the property owner and others, depending on the state statute. The time limit is generally connected with the last date on which the goods or services have been supplied to a particular job. The subcontractor must also record a claim of a lien in the county filing office. The mechanic's lien attaches to property immediately when the claimant supplied the labor or materials. The claimant must initiate a legal proceeding by filing a complaint for a foreclosure and records a notice of lis pendens. The vendor must be mindful that each state's lien law may vary in terms of notice requirements and protection afforded the vendor.

Interplay of Federal Bankruptcy Preference Law and State Lien Law

Whether a vendor who is protected under a state's lien law, must return preference payments when the general contractor files bankruptcy raises the doctrine of preemption. A state's lien laws are created by the state legislature, while the bankruptcy laws are created by Congress and are a federal statutory scheme.

Preemption may exist if Congress passes a federal law that is intended to block enforcement of a state law, here the lien laws. While Congress crafted the Bankruptcy Code to cover most aspects of debtors and their creditors, there a number of state laws that also govern these rights.

Where a court is requested to interpret whether a state law, here the lien law, is preempted by a federal law, here the Bankruptcy Code, the inquiry is whether the state law conflicts with the federal law. In a recent decision, the bankruptcy court in *In re IT Group, Inc.*, considered whether the bankruptcy laws preempted a state's lien, thereby opening the door for vendor to face a preference claim.

Preference and the Subcontractor

In *In re IT Group*, the debtor's creditors' committee sued two of its material suppliers for payments received during the preceding 90 days the debtor's bankruptcy filing (preferences). The suppliers sought to have the preference actions dismissed as the transfers were trust property under state lien law and thus was not property of the estate.

In opposition to dismissal of the preference action, the creditors' committee contended that the preference provision was intended to ensure equitable distribution to all the creditors. The material suppliers cited to cases wherein courts found that funds held in trust under state law for the benefit of subcontractors and material suppliers was not a preference.

The bankruptcy court concluded that the material supplier and subcontractor were entitled to judgment in their favor because the state lien law created a statutory trust. The funds were not property of debtor's bankruptcy estate because the funds received by the general contractor for the improvement of real property is to be held in trust for the benefit of the subcontractors. The court noted that the preference defendants provided labor, services, and materials in connection with the prime contracts and therefore the preference actions should be dismissed. The court observed that the Bankruptcy Code did not preempt the state lien law.

Conclusion

The *IT Group* decision encourages the subcontractor and material supplier to continue supplying their financially struggling general contractor. While the *IT Group* court underscores that the particular state's lien law protects the vendor from a preference claim, be mindful that the state lien laws are statutory and thus may vary from state to state. Vendors may use the *IT Group* ruling as a means to negotiate a dismissal or reduction in the preference demand, depending on the state lien statute.

Guest Column

U.S. AUTOMOTIVE INDUSTRY: CREDIT EXECUTIVES' LATEST CHALLENGE

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On October 20, 2006, CBS news reported that Ford would shutter l6 plants and hopes to cut 30,000 hourly jobs by the end of 2008. Ford reportedly has also offered buyout or early retirement offers to 75,000 works.

On October 21, 2006, The Detroit Free Press reported: "In the next two weeks, Detroit auto suppliers are likely to report declines in their third-quarter earnings per share because Detroit's automakers have scaled back production, forcing suppliers to make adjustments.

DaimlerChrysler AG has said it will cut North American production by 16%, or 35,000 units, in the second half of the year. General Motors Corp. estimates its North American production will be down 12% in the final three months of the year, or about 50,000 units, from the fourth quarter of 2005. And Ford Motor Co. plans to cut its North American production by 21% or 168,000 vehicles, in the final three months of the year

Lear Corporation, Visteon Corporation and Johnson Controls, Inc. have all previously reported they have already begun layoffs in an effort to keep pace with the automakers schedules. American Axle & Manufacturing Holdings, Inc. has offered buyouts to 6,000 employees to align its workforce with reduced customer orders."

On October 28, 2006, BorgWarner reported its profits were off 36 percent and it missed its forecast. In September, BorgWarner cut about 850 jobs, or 13 percent of its North American workforce due to a production slump.

Also on this date, the Timken Co. announced that 700 workers would lose their jobs. "Friday's announcement was about matching demand in the market place," President and Chief Executive Officer, James W. Griffith said.

"The automotive business has continued to lag behind Timken's industrial bearing and steel groups, posting losses in quarterly returns. Griffith said the latest cuts will fit with the company's push to diversify its customer mix.

The general direction of the company has been to lessen our dependence on the automotive market and the Big 3 specifically," he said."

Several credit executives within the automotive sector were questions about the pressures being placed upon their respective firms by the events described above. Speaking on the condition of anonymity, their comments are as follows:

"Many of my fellow credit professionals in the automotive related industries are running scared. Despite the recent bankruptcy filings, production cutbacks, plant closures and labor-force layoffs, we are still under pressure from our executive management to protect our accounts receivable assets and minimize losses."

"Numerous suppliers to the automotive parts industry must rely on off-shore sources for their raw materials such as copper, aluminum and steel. While we do our best to hedge on pricing in the international market place, we are being squeezed by the 'big auto parts suppliers' to cut prices and adjust production schedules to fit their schedules, while at the same time stretching us out on payment terms."

"Prior to filing bankruptcy, several of the '800 lb gorillas' in the industry had come to us with 'strong requests' for extended payment terms, with the threat of taking their business elsewhere. Since their bankruptcy filings, the same firm are voicing the same threat and still requesting extended terms."

"Our firm has historically done business within the industry under contractual terms, which in some cases covered purchases over an extended period. Efforts to renegotiate the terms and period of these contracts prior to the bankruptcy filing of one customer were unsuccessful. Now, since their bankruptcy filing, they have filed a motion with the court to cancel the contract as 'being unprofitable'."

"My firm was not a direct supplier of parts or materials to the automotive industry, rather we supplied construction materials to one of the parts supplier's plant expansion. Despite our properly filed lien rights, we were forced to hire an attorney to represent us in the bankruptcy proceedings."

"The 'Attitude Adjustment" hour usually held before the beginning of our industry credit group meetings now begins the night before the meeting and continues through to the following day. In the words of Alfred E. Newman, 'What, Me worry?' "

"My staff is spending more and time on deduction resolution. Customers have been increasing the number and value of deductions taken from payments to us, shifting the burden of 'proof' to us. Not only is this time consuming for my staff in terms of resolving the issues, it really constitutes an interest free loan to the debtor for the time it takes for resolution, which requires much haggling back-and-forth and in some cases can take up to six months."

"Not much has changed within the automotive and related industries. My experience in the industry dates back to the mid-80's and even then the big players in the industry were pretty much dictating terms to the vendors who chose to do business with them. The same games are being played today as back then; payments delayed beyond terms; unauthorized deductions and continual pressures to reduce prices. All the while, we are expected to 'do more with less'."

As events continue to play out within the automotive sector, which dominos will topple next?……..Lyons and Tigers, [but no Bears]? Oh my……….sorry, I couldn't resist. Seriously however, one of the dominos to fall within the near future will be the filing of preference actions against creditors for the recovery of payments made by the auto parts suppliers within the ninety (90) day "preference period" prior to the filing of their petitions for protection under Chapter 11 of the United States Bankruptcy Code.

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YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

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this situation, how does the vendor make the critical vendor list? What points does the credit executive negotiate with the debtor before committing to a critical vendor contract? What is the impact of the Bankruptcy Reform Act to measuring postpetition credit risk, including available cash to fund critical vendor payments as well as pay postpetition credit extensions? If the credit executive cannot negotiate a satisfactory critical vendor contract, what alternatives are available for the credit executive to preserve the sale to the Chapter 11 debtor?

A. History of the Critical Vendor Doctrine

Since the early 1990's, Chapter 11 debtors have asked bankruptcy courts to approve payment of vendors' prepetition claims that it believes is essential to its ongoing operations. Payment of these claims has been allowed in the interest of enabling a reorganization that is expected to benefit all creditors, including those that are not designated as a critical vendor. In some jurisdictions, a motion to authorize payment of critical vendors' prepetition claims has become a common first day motion in a Chapter 11 case, wherein the debtor articulates its business judgment to support payment of critical vendors.

1. The Equality of Payment Rule for Unsecured Creditors in Bankruptcy

A central principle of the Bankruptcy Code is equality of treatment of unsecured creditors. The equality of treatment rule is embodied, for example, in the preference laws and treatment of creditors' claims under a plan of reorganization. Creditors of the same priority are generally not entitled to be paid on their prepetition claims in Chapter 11, except through a plan of reorganization, and vendors are to be paid the same pro-rata amount on their claims in both Chapter 7 and Chapter 11 cases.

2. Development of the Necessity Doctrine

Notwithstanding the general rule of treating creditors of the same class equally, bankruptcy courts have often relied on the "doctrine of necessity" to allow insolvent debtors to pay vendors whose cooperation is deemed essential to a debtor's continued operations and reorganization. The same doctrine has been routinely invoked to justify payment of the prepetition claims such as claims of a debtor's employees for unpaid wages and benefits.

The necessity doctrine developed in railroad receivership cases of the nineteenth century. Survival of the railroad industry was essential to a large segment of the economy and communities in many regions of the United States, courts were willing to be very flexible in allowing receivers overseeing reorganizations of railroads to exercise remedies necessary for a struggling railroad to survive. These measures included the necessity of payment rule, which allowed payment of certain claims that arose before receivers were appointed. Under this doctrine, claims made by suppliers and other entities essential to railroad operations could be paid ahead of claims that would otherwise have priority, including claims of secured lenders.

3. The Necessity Doctrine Outside of Railroad Reorganizations

In the twentieth century, courts began applying the doctrine of necessity to reorganizations of businesses other than railroads, including businesses whose survival was not necessarily linked to the public interest. The doctrine of necessity is believed by its proponents to be incorporated within a bankruptcy court's general equitable powers under section 105(a) of the Bankruptcy Code.

The legislative history of section 105 (a) suggests that this section incorporates equitable powers that bankruptcy courts were previously understood to possess. The United States Supreme Court has stated that it will not read the Bankruptcy Code to erode the past bankruptcy practice absent a clear indication that Congress intended such a departure.

4. The Modern Approach to Critical Vendor Payments

During the past fifteen years, bankruptcy courts in a number of jurisdictions have been inclined to authorize debtors to pay repetition claims of vendors deemed critical, based on a debtor's business judgment. The concept of "critical vendor" had gone from an extraordinary remedy to something that is done as a first day motion filed by debtors in chapter 11 cases.

However, during the last four years, critical vendor payments have come under increased criticism by some courts, bankruptcy attorneys, and scholars. Some critics have noted that there is no provision in the Bankruptcy Code that expressly allows for payment of critical vendors ahead of other creditors. Other critics have maintained that the Bankruptcy Code may allow critical vendor payments, but have argued that this practice has been abused with payments being authorized when a vendor is not truly necessary to a debtor's reorganization. This criticism culminated in the Kmart appellate rulings.

B. The Critical Vendor Doctrine

To be classed as "critical" by a Chapter 11 customer is usually an extraordinary result for the vendor as it usually 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 vendor class is limited, especially with the enactment of the Bankruptcy Reform Act, and the constraints imposed by the Seventh Circuit Court of Appeals under the Kmart decision. Further, 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 scrutinize (and possibly object) to the critical vendor request.

Critical vendor motions are more common -— and more scrutinized than ever. Bankruptcy judges are now often insisting on detailed support to pay a vendor immediately on their prepetition claim. 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.

A number of courts throughout the

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country have carved an exception to this general rule and labeled it the critical vendor doctrine. Under the doctrine, a debtor may pay certain prepetition claims, with court approval, at the commencement of the bankruptcy case where it can be established that payment of those claims will help to stabilize the debtor's business without significantly harming any party.

The payment of these claims 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 post-petition. 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.

1. Selling to a Chapter 11 Debtor Invoice by Invoice Compared with an Executory Contract

A vendor that has sold a debtor on an order-by-order basis has no continuing obligation to sell the Chapter 11 debtor. Because of this, the vendor has leverage on whether to sell the debtor. An element of the debtor's critical vendor request is that the vendor provides a product or service that is indispensable for its continued operations. Should the critical vendor decide not to provide the product or service, the prospects for the debtor's reorganization is diminished.

However, with the vendor who is a party to an executory contract, such as a long-term supply contract, the debtor may seek to compel the vendor to comply with the terms of the contract. The automatic stay bars the vendor that is a party to an executory contract with the debtor from terminating the contract postpetition, without bankruptcy court authorization. Thus, only those vendors selling invoice by invoice should have the leverage to seek critical vendor status. Having said, that debtors have given critical vendor status to vendors that have executory contracts.

C. Notwithstanding the Kmart Decision, the Critical Vendor Doctrine Continues

Kmart's Chapter 11 was one of the largest filings by a retailer. In an effort to obtain unsecured credit from its vendors and maintain key vendor relationships, Kmart, in the opening days of the bankruptcy, rewarded certain key domestic and foreign vendors with payment on their prebankruptcy claims under the critical vendor doctrine. As part of its first-day motions, Kmart filed a motion seeking authority to pay prepetition obligations to its critical vendors. Kmart served its critical vendor motion on about 65 of its key creditors, notwithstanding it had thousands of vendors. Kmart argued these payments were necessary to maintain business relationships with the respective vendors, and the vendors' goods were essential to Kmart's continued operations and a successful reorganization.

Vendors supplying a range of products from food to music to publishing services were paid on their prepetition claims in exchange for these vendors providing post-petition trade credit. The critical vendors agreed to provide credit on customary trade terms for two years. The bankruptcy court authorized payments to the critical vendors totaling $327 million under the "doctrine of necessity" using its equitable powers of section 105 of the Bankruptcy Code. The bankruptcy was satisfied with Kmart's business judgment that without paying vendors their prepetition debt the vendors would not make shipments postpetition, and without these goods Kmart's reorganization would be threatened.

The Seventh Circuit Court of Appeals affirmed the district court's reversal of the bankruptcy court's approval of the debtor's critical vendor motion. The Seventh Circuit's decision does not flatly reject the critical vendor doctrine, but it does indicate that a debtor seeking authority to pay its critical vendors must be prepared to satisfy heightened procedural and evidentiary standards.

The Seventh Circuit noted that the bankruptcy court ruling was overbroad where the court had allowed unlimited permission to pay any debt deemed critical. Rather, the debtor must identify which vendors are critical.

The debtor must establish: (1) Such payments are in fact critical to their reorganization; (2)Discrimination among unsecured creditors is the only way to facilitate a reorganization; (3) Non-critical vendors will be at least as well off as they would otherwise be if the critical vendor order is not entered; and (4) Such payments will not diminish the amount of funds that ultimately will be available for payment to non-critical vendors. In addition, the Seventh Circuit has expressed concerns about notice of a critical vendor motion to non-critical vendors.

D. Bankruptcy Reform Act Does Not Bar Critical Vendor Doctrine, But Debtor's Cash Availability Restricted

The Bankruptcy Reform Act is silent as to the critical vendor doctrine. Therefore, debtors are free to request the bankruptcy courts approve critical vendor motions. However, debtors will likely have less cash and liquid assets available to fund critical vendor requests as a result to changes brought by the Reform Act. Likewise, vendors must be more vigilant with their postpetition credit analysis as a result of changes brought by the Reform Act.

With the development of the critical vendor doctrine, vendors found themselves committing to long term sales contracts—on credit-in exchange for payment on their prepetition claims. Even those vendors that did not qualify as "critical"-an amorphous standard-considered selling their Chapter 11 customers with the added inducement of a junior lien on the customer's assets. Some vendors, eager to continue the sale of its goods or services, would sell without any credit enhancements.

Prior to October 17, 2005, vendors would often measure postpetition credit risk by whether the debtor had obtained post-petition debtor-in-possession financing. If a satisfactory DIP facility had been obtained, the vendor would sell on credit. However, with the arrival of the Bankruptcy Reform Act of 2005, the credit risk model used by credit executives for selling to Chapter 11 debtors may have fundamentally changed.

A debtor's cash availability is restricted under the Reform Act as a result of provisions favoring special creditor interests. Some of the provisions include:

(*Continued on page 8*)

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

(*Continued from page 7*)

1. Employee Wages

Prior to the Reform Act, employee wages were given priority up to $4,000 for each individual earned within 90 days before bankruptcy. Under the Reform Act, employee wages and salaries are increased to $10,000 for each individual up to 180 days before the bankruptcy.

2. Landlord Claims

Under the Reform Act, a debtor must assume or reject its real estate lease within 120 days following the petition date. A court may extend the 120 day period to assume or reject for up to an additional 90 days. Further extensions require the lessor's consent. Early assumption requires the debtor to dedicate more of its liquid assets to the early stage of the case.

3. Utilities

Under the Reform Act, a debtor offering a utility an administrative expense claim no longer constitutes adequate assurance of payment. Adequate assurance of payment is limited to: a cash deposit; a letter of credit; a certificate of deposit; a surety bond; a prepayment of utility consumption; or another form of security that is mutually agreed on.

4. Reclamation

The Reform Act expands the time for reclaiming creditors to make their reclamation demand to 45 days after the debtor receives the goods or 20 days after the bankruptcy. The value of the goods shipped to the debtor within 20 days prior to the bankruptcy are given an administrative claim. This means that more of the debtor's assets will be dedicated to reclamation claims.

E. Making the Critical Vendor List

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment. The debtor places the "critical" vendors on a list. Those vendors that do not make the list will receive payment through a confirmed plan of reorganization or Chapter 7 liquidation, often years after the filing, even after the Bankruptcy Reform Act that pressures debtors to exit bankruptcy earlier.

The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment on the prepetition claim. The order approving the motion also binds the vendor that agrees to critical vendor status to continue to sell with the debtor on terms equal to or better than pre-petition terms. The responsibility to define the vendors typically has been placed in the hands of the debtors. When a company files for bankruptcy, it reviews a list of its vendors and decides which ones are critical in order to stay in business.

Another strategy for a debtor is not identifying their critical vendors in court pleadings, which are public documents, to avoid alienating those vendors who don't make the list. It seems the leverage of the critical vendor request may be shifting from the vendor to the debtor. The vendor may hold out continued sales to the debtor thereby threatening the debtor's ongoing operations, perhaps only to find a replacement vendor who qualifies as a critical vendor.

1. Dealing with the Automatic Stay

The automatic stay is an injunction that automatically and immediately goes into effect upon the bankruptcy filing. It is filed, whether the bankruptcy filing is one under Chapter 7 or 11.

The automatic stay prohibits any creditor from taking action against the property of the estate and against the debtor, unless relief from the stay is obtained. For example, a vendor is barred from seeking or levying writs of attachments or garnishments, and also stays the vendor from a judicial lien against the debtor, but has not yet levied on any property.

The creditor needs to be mindful when requesting critical vendor status that the manner in which the request is made does not violate the automatic stay. To that end, the creditor should consider contacting the customer (debtor) and determine who within the company is responsible for the critical vendor program. Once that contact is identified, the vendor may negotiate with the representative to make the list.

F. Negotiating Points for the Critical Vendor

The postpetition vendor agreement will control the terms of sale between the debtor and the vendor under the critical vendor agreement.

1. How Much Are You Getting Paid?

The critical vendor doctrine has evolved from the debtor requesting a particular vendor be paid immediately as a critical vendor, to the debtor requesting a class of vendors qualify as critical vendors, to the debtor requesting the bankruptcy court establish a critical vendor "trade claims cap". For example, in the United Airlines Chapter 11, the carrier requested that the bankruptcy court pay trade claims totaling $35 million as critical. United Airlines did not identify the vendors it would deem critical. Rather, United Airlines requested the court authorize payment of a class of vendors it deemed critical which represented about 14% of vendors unsecured claims. United Airlines did not propose to pay in full each vendor deemed critical, but only the minimum for the vendor to continue selling on credit.

2. Length of Postpetition Trade Commitment

How long are you committing to provide your product or service? Through confirmation? Post confirmation? With the development of the critical vendor doctrine, vendors found themselves committing to long term sales contracts—on credit-in exchange for payment on their prepetition claims. Even those vendors that did not qualify as "critical"-an amorphous standard-considered selling their Chapter 11 customers with the added inducement of a junior lien on the customer's assets. Some vendors, eager to continue the sale of its goods or services, would sell without any credit enhancements.

Prior to October 17, 2005, vendors would often measure postpetition credit risk by whether the debtor had obtained postpetition debtor-in-possession financing. If a satisfactory DIP facility had been obtained, the vendor would sell on credit. However, with the arrival of the Bankruptcy Reform Act of 2005, the credit risk model used by credit executives for selling to Chapter 11 debtors may have fundamentally changed.

(*Continued on page 9*)

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

(*Continued from page 8*)

3. Debtor Defaults on Postpetition Credit Purchase

If the debtor fails to pay per invoice terms what are your rights? Can you revoke your postpetition credit contract, yet preserve critical vendor payment? How do you get paid on the delinquent invoices?

4. Postpetition Credit Risk

The vendor needs to ensure that its postpetition credit does not exceed its prepetition debt, unless comfortable with the credit risk. For example, the vendor may have a nominal pre-bankruptcy balance, yet the debtor is entering their selling season, and therefore under the terms of a common critical vendor agreement, the vendor has committed a sizeable postpetition credit risk. As noted, with debtors filing Chapter 11 under the Reform Act, vendors must be mindful that they have less cash to meet operating expenses. Therefore, there may be even greater credit risk for the vendor contracting for postpetition credit sales.

In evaluating the credit risk under the Reform Act, the vendor needs to consider the cash commitment and administrative claims that the debtor faces at the filing date as well as the confirmation of the plan.

5. Amount of Postpetition Credit Terms

What are the postpetition credit terms the debtor expects the vendor to commit to qualify as a critical vendor? The debtor commonly insists that the vendor provides terms most favorable terms in the past six months. Generally, the debtor forwards a letter agreement reciting the terms of the postpetition agreement.

Recent trade credit agreements approved by courts have required vendors to provide postpetition credit through confirmation of the Chapter 11 proceeding. If the vendor breaches the postpetition credit agreement, that may be cause for the vendor to disgorge the payment on account of the prepetition claim.

If the postpetition trade credit agreement does not contain a provision that allows for the vendor to terminate the trade relationship should the debtor fail to pay according to the credit terms, the vendor should write in such a provision. Further, the vendor may want to include a provision that permits the vendor to terminate the trade relationship if the debtor falls below key financial ratios, even if the debtor has not defaulted on the postpetition credit agreement. This would allow the vendor to hold orders in the face of a debtor's deteriorating postpetition financial operations.

6. Timing of Critical Vendor Payment

When do you get paid on your prepetition debt? Is the debtor attempting to force vendors to ship on credit prior to making the critical vendor payments. The vendor should negotiate immediate payment for the full amount, if possible. You may be able to do this through assumption of your contract, also.

7. Payment Terms on Prepetition Debt

a. Immediate Payment in Full

As noted, the vendor should negotiate immediate payment in full of the its prepetition claim.

b. Payments Over Time

Another alternative a debtor may offer to vendors immediate payment in full of its critical vendors, is to pay those vendors prepetition claims over time, for example over several months. As with the percentage payment, there is no legal basis that requires a debtor to pay the vendors' prepetition claim immediately.

c. Payment of Less than 100%

Under a critical vendor cap, the debtor may offer only a percentage of each trade claim to be paid, say 60%. This allows the debtor to offer more vendors to participate in the critical vendor program, and thereby increase the amount of postpetition trade credit.

d. Cross-Collateralization Provision

A debtor may insist that the critical vendor payments be paid through the vendor's future shipments. In other words, when the vendor ships postpetition on credit, the debtor's payment on the postpetition sale pays down the prepetition debt. The vendor's postpetition debt builds up, which is entitled to administrative priority, and is ultimately paid down after the cross-collateralized prepetition debt is paid.

7. Debtor Waivers to Protect the Critical Vendor

The vendor should negotiate certain waivers to ensure that the critical vendor payment made is not later clawed back.

a. Preference Waiver

Although the vendor may be deemed a critical vendor, that designation does not protect the critical vendor from a preference suit for payments received during the preference period. The vendor should insist on a preference waiver, for any payments you received during the preference period. Absent an express waiver that is approved the bankruptcy court, you are at risk of a trustee demanding the return of the preference payment.

b. Disgorgement Waiver in the Event of Conversion

Does the critical vendor face risk that the critical vendor payment may be clawed back if the Chapter 11 be converted to Chapter 7 liquidation? If the critical vendor order provides that the vendor is free from such claims if the case converts from a Chapter 11 to a Chapter 7, that language should protect the vendor from any later claims asserted by a Chapter 7 trustee.

c. Disgorgement Waiver in the Event of an Appeal

Kmart has raised the issue of whether a vendor that is selected as a critical vendor may later be sued to recapture the critical vendor payment in the event the critical vendor order be reversed, even if the vendor extended credit to the debtor as required under the critical vendor order. A vendor should consider including a provision in the critical vendor order that bars a claw back of the critical vendor payment should the order be reversed. The most effective way to gauge this risk is whether the critical vendor order was appealed. The general rule is that the critical vendor order must be appealed within 10 days of entry. Should a party fail to timely do so, the appeal is lost.

(***Continued on page 10***)

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

(Continued from page 9)

8. Proving up Uniqueness

Although the debtor files the motion with the bankruptcy court to approve critical vendor status, with those courts following the Kmart decision, the vendor may be required to provide specifics for the bankruptcy court, as well as creditors, as to why vendor is so valuable to justify paying its claim ahead of other vendors. To that end, the vendor should review the debtor's motion to pay critical vendors and determine whether the debtor has classified vendors. Below are examples of types products or service that may qualify the vendor as unique. Likewise, below are examples where the competitive situation may make the vendor unique.

a. Sole Source Vendors

Some vendors may be a debtors' only providers of essential materials or services. There may be no replacement vendors for sole source vendors. Even should competing vendors exist, a debtor may classify certain vendors as sole source vendors where the transition to a new vendor may interrupt a debtor's operations. Where a vendor is the only sole source vendor who readily can provide a debtor with materials or services, it may refuse to continue materials or services due to the prepetition indebtedness, and the debtor's operations could be disrupted while the debtor seeks to locate a substitute vendor, in excess of the amount of sole source suppliers' prepetition claims.

b. Capacity Vendors

Some vendors of materials may be the only vendors to produce such materials in quantities sufficient to meet a debtor's demands, even though there may be vendors that produce some of the materials.

c. Quality Vendors

Some vendors may be deemed critical as they are the only vendors that provide the debtor with certain high-quality materials. In some cases a debtor may have customer contracts that require the high quality materials.

d. Knowledge Vendors

Some vendors may be deemed critical because they have unique knowledge of a debtor's business, or have been responsible for certain aspects of a debtor's business. These vendors have maintained the debtors operations for a period of time and have acquired unique knowledge of the business.

e. Vendors Providing Unique Service

Specialized service vendors are similar to unique product vendors, except that their uniqueness lies in their service instead of their goods.

f. Lack of Competition within Industry

Lack of competition within an industry may give a vendor leverage over the debtor and result in critical status for the vendor. Rather than a unique product or service that a vendor may provide, the mere fact that the vendor lacks competition creates the critical vendor situation.

g. Foreign Vendors

Vendors that provide their product from overseas may create a critical vendor situation. Offshore vendors may find that the debtor cannot find a replacement vendor in a timely manner.

h. Vendors Selling to Companies Subject to Mass Tort Claims

Over the last few years, companies that used or consumed asbestos in their operations (as opposed to manufacturers of asbestos) have been shocked to find themselves the target of mass asbestos litigation and personal injury claims.

This mass asbestos litigation has resulted in scores of companies filing Chapter 11 to stay this litigation. In the asbestos and mass tort cases, debtors generally have sought critical vendor status for a large portion of its vendor class.

i. Small Vendors

Those vendors whose financial survival is dependent on the debtor paying their prepetition claim have qualified as a critical vendor.

G. If You Are Unable to Negotiate Favorable Points to Support Critical Vendor Status, Consider Critical Vendor Alternatives

1. Selling on Credit Postpetition

To encourage vendors to sell a debtor postpetition on credit, 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 vendor's prepetition claim.

a. The Catch Up Issue

If the vendor does not qualify as a critical vendor, the vendor may decide to find an alternative to have its prepetition claim paid. A vendor may not be paid on its prepetition claim post bankruptcy. 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.

2. Junior Lien Sales

To those vendors who do not qualify as critical, a debtor may offer a junior lien on assets in exchange for their 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. Therefore, this alternative is more risky for the vendor.

3. 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 vendor'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 its claim does so usually at a steep discount.

4. Payment of All Vendors' Claims Through Prepack

(Continued on page 11)

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR, NOW WHAT? NEGOTIATING POINTS

(*Continued from page 10*)

If a debtor is contemplating Chapter 11, it may negotiate with its major creditor constituencies, 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.

F. Consider Negotiating Points of Critical Vendor Agreement

The courts application of the critical vendor doctrine continues to evolve. Debtors more frequently request courts' approval of the critical vendor program. Where the doctrine is approved, courts reason, both the debtors and creditors stand to gain something. The critical vendor benefits by receiving early payment on its prepetition claim. The debtor and its vendors benefit by receiving needed product on credit, which may lead to a successful reorganization. A vendor being deemed an essential vendor can have a dramatic impact on the account. The credit executive is not forced to wait what may turn out years for uncertain payment from a reorganizing debtor. But consider negotiating favorable terms including waivers before committing to postpetition trade credit.

Exhibit A: Post-bankruptcy Critical Vendor Agreement

[DEBTOR]

____________, 200_

TO: [Critical Trade Vendor]
[Name]
[Address]

Dear Vendor:

As you are no doubt aware, [DEBTOR NAME] and certain of its affiliates ("Debtors"), filed a voluntary petition under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy court for the District of ______________ on ________________ (the "Petition Date"). On the Petition Date, we requested the Bankruptcy court's authority to pay certain suppliers. On _________200_, the Bankruptcy Court authorized us to pay prepetition claims of certain trade creditors that agree to the terms set forth and to be bound by the terms of the Order.

In order to receive payment on prepetition claims, each selected trade creditor must agree to continue to supply goods to the Debtors based on "Customary Trade Term." Customary Trade Terms are defined as the normal and customary trade terms, practices and programs (including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowances, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs) in effect between such trade creditor and the Debtor for the period prior to the Petition Date or such other trade terms that are at least as favorable as those that were in effect during such time.

For purposes of administration of this trade program as authorized by the Bankruptcy court, the Debtors and you agree as follows:

1. The balance of the prepetition trade claim (net of any setoffs, credits or discounts) (the "Trade Claim") that the Debtor will pay you is $__________________.

2. You will provide open credit terms as follows:
____

3. The open trade balance or credit line that you will extend to the Debtor for shipment of postpetition goods is $___________ : ((a) on __________200___, or; (b) on normal and customary terms on a historical basis for the period immediately before the Petition Date).

4. Payment of your claim may only occur upon execution of this letter by a duly authorized representative of your company and the return of this letter to the Debtor.

Sincerely
[Applicable Debtor]

By:___________________________
Its:_______________________

Agreed and Accepted by:
[Name of Trade Vendor]

By: _________________________

Its:_______________________ Dated: _______________________

RETURNED INVENTORY AS A PREFERENCE CLAIM: WHAT IS THE VALUE?

(*Continued from page 1*)

of $11,428.88. Thereafter, the creditor picked up all of the unused yarn it had previously sold to the debtor, and the debtor credited $134,849.50 against its outstanding indebtedness to the creditor for the returns.

An involuntary chapter 7 petition was filed against the debtor within 90 days of the creditor's recovery of the yarn. An order for relief was entered, and the debtor converted the case to chapter 11. Thereafter, the debtor commenced a lawsuit against the creditor for avoidance of the debtor's prepetition return of the creditor's yarn and recovery of the value of the yarn. The bankruptcy court held that the returns to the creditor were an avoidable preference for which the debtor was entitled to recover the liquidation value of the returns in an amount equal to $27,459. The debtor appealed the bankruptcy court's order, arguing that the creditor should have been directed to pay the fair market value of the returns equal to the amount the creditor could have realized from reselling the returned yarn.

The district court limited recovery on the debtor's return-of-inventory preference claim to the sums the debtor could have realized from a liquidation sale of the returns. The district court, relying on the pre-Bankruptcy Code decision of the U.S. Court of Appeals for the Fourth Circuit in Virginia Nat'l. Bank v. Woodson (In re Decker), 329 F.2d. 836 (4th Cir. 1964), noted that the recovery from the debtor should be based on the extent to which the return had depleted the debtor and its bankruptcy estate. The yarn's value to the debtor was the amount the debtor could have realized from a liquidation sale of the yarn. The court refused to give the debtor any credit for any greater recovery the debtor derived from its disposition of the returned yarn, which the court attributed to the creditor's expertise, time, goodwill and advertising.

As indicated, it is important to recognize that courts have employed several other methods to determine the recovery on a return-of-inventory preference claim. For example, the bankruptcy court from the District of Massachusetts in *In re First Software Corp*. entered a judgment in the amount of $1,500,026 against the creditor on a return-of-inventory preference claim. The court simply relied on a credit memorandum in the above amount issued by the creditor in reduction of its claim. The credit memorandum was deemed the creditor's contemporaneous determination of the market value of the returns.

Another commonly cited case is from the bankruptcy court in the Middle District of North Carolina in *In re American Furniture Outlet USA Inc. (American Furniture Outlet USA Inc. v. Woodmark Originals Inc.)*, which refused to base the recovery on a return-of-inventory preference claim on a credit the creditor had issued for past-due invoices owing by the debtor. Instead, the court limited recovery to the net amount, after deducting expenses, that the creditor had realized from its commercial resale of the returned inventory.

Other courts dealing with a return-of-inventory preference claim have ordered the creditors to return the inventory, when conflicts arise as to the valuation of the inventory and no clear valuation can be made.

Unfortunately, there is very little case law on the application of the ordinary course of business and new value defenses in return-of-inventory preference cases. As such, to creditors faced with such preference demand, the decision from *Active Wear Inc. v. Parkdale Mills Inc.* may provide those creditors with the only way to reduce their preference exposure.

COURT MAY REFUSE ORDINARY COURSE OF BUSINESS DEFENSE BASED ON THE METHOD USED IN APPLYING PAYMENT TO OUTSTANDING INVOICE

(*Continued from page 2*)

was on account of an antecedent debt.

The supplier argued that even if the payments were preferential, the plan administrator could not avoid the payments under the ordinary course of business defense. The supplier introduced the testimony of its general manager in support of its ordinary course defense. The general manager testified that the debtor remitted payment to the supplier on an average of 44 days after it received the invoice during the pre-preference period compared to an average of 42.68 days during the preference period. Also, the range of time between the debtor's payment and receipt of invoice during the pre-preference period was 14 to 105 days compared to a range 21 to 77 days during the preference period.

However, the court stated that the supplier failed to show that the terms under which the debtor remitted the payments were objectively ordinary. The supplier must established that the payments were objectively ordinary in relation to the standards and terms prevailing among similarly situated companies within the relevant industry with respect to the type of transaction in which the debtor made the payment.

Here, the supplier failed to demonstrate that its practice allowing the debtor to direct how the supplier would apply each payment fell within the general range of terms within the computer resale industry. The supplier's general manger failed to testify as to the industry practice concerning the method by which suppliers apply a customer's payment to outstanding invoices. The supplier's controller testified that the supplier had no written policy concerning how it would apply each payment with respect to outstanding invoices. Rather, customers would remit payment direct to its bank and the bank would then inform the supplier that a customer remitted a payment and which invoices the payment covered.

The court concluded that the supplier could not rely solely on its own policy to meet its burden of proof. Rather, the supplier was required to produce evidence of industry practice concerning how suppliers apply a customer's payment to outstanding invoices to establish the general terms prevailing with in the industry.

The supplier did not provide any evidence concerning how creditors apply customer's payments within the computer resale industry beside its own informal policy. Thus, it failed to establish that its practice of allowing the debtor to direct which payments should apply to which invoices fell within the general terms prevailing in the computer resale industry.

IMMUNIZING PAYMENTS FROM PREFERENCE RISK: THE CREDIT CARD DEFENSE?

(*Continued from page 1*)

files bankruptcy within 90 days of making payment, what is the preference risk? The Bankruptcy Code vests the debtor (or trustee if one is appointed) with far-reaching powers to avoid transfers of assets and monetary transactions prior to a bankruptcy filing. The power to avoid preferential transfers is one of the most powerful weapons a trustee has.

The Bankruptcy Code defines a preference expansively to include nearly every transfer by an insolvent debtor 90 days prior to bankruptcy. The purpose of the preference provision is two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

The debtor has the burden of proof to establish the following elements of a preference: (1) a transfer of property of the debtor; (2) transfer on account of an antecedent debt; (3) presumption of insolvency within 90 days of bankruptcy filing; (4) within 90 days (one year if an insider) before the filing of bankruptcy; (5) that enables the creditor to receive more than it would have received in a liquidation.

At issue in the *Perry* case was whether the debtor's payment by credit card constituted a transfer of property of the estate, the first element the trustee has the burden to establish.

1. Property of the Estate

The Bankruptcy Code and case law defines property of the estate broadly to include all interests of the debtor in property as of the bankruptcy filing.

2. Transfer of Property of the Debtor

The Bankruptcy Code defines a property transfer broadly to include every direct or indirect, absolute or conditional, voluntary or involuntary, disposing of the debtor's property.

The inquiry is whether the transfer diminished or depleted the cash available for distribution to creditors. By contrast, if the debtor transfers property that would not have been available to distribute to creditors, then no preference.

C. The Trade Relationship: Customer Pays by Credit Card for B2B Transaction

In *In re Perry*, the vendor provided goods on terms to the debtor, a sole proprietor. The debtor paid for the credit sale using his credit card. The debtor filed chapter 7 liquidation within 90 days of paying the vendor by credit card. The bankruptcy trustee sued the vendor to recover the credit card payment. The vendor sought dismissal of the preference contending that the payment by credit card was not property of the estate.

D. Decrease of Credit Line Not Transfer of Property

The *Perry* court considered the trustee's contention that payment by a credit card constituted property of the estate. The court found it did not:

> Despite the broad scope of $ 541, the payment at issue was not a transfer of the property of the estate. The payment constituted merely a transfer from MBNA to [*vendor*]. Debtor's estate was only implicated by this transfer insofar as MNBA decreased the credit allowance under Debtor's credit card account. Since the payment was a transfer of mere credit, and did not affect the amount of liquidity or property available for distribution by the estate's creditors, the payment was not a transfer of an interest of the debtor in property.
>
> * * *
>
> At most, a debtor's credit constitutes merely potential wealth. Creditors of an estate cannot force a debtor to use credit to create liquidity available for distribution. It is true that creditors benefit from a debtor's credit where the debtor elects to purchase property or borrow funds from a credit card account. However, credit on its own serves no immediate benefit to the estate in bankruptcy. [3]

The ruling underscores that what is property of the bankruptcy estate depends on what the debtor does leading up to the preference period. Thus, if a credit executive is skilled at extracting payment from the debtor through a credit card during the preference period, the *Perry* court will not upset that.

E. Common Preference Defenses not Needed for Credit Card Defense

The most commonly asserted preferences by vendors are the contemporaneous exchange defense, the ordinary course of business defense and the new value defense. If the vendor sells on a secured basis, such as with a purchase money security interest, the vendor may have an enabling loan defense. In addition, vendors may have procedural defenses, including the statute of limitations defense, standing defense and demand for jury trial. The trustee generally has no duty to investigate and consider a vendor's preference defenses, as it is the vendor's burden to establish the defenses.

As noted, the *Perry* court did require the vendor to establish the elements of the preference defense. The credit card defense shifts the burden of proof from the vendor to the trustee. The trustee must prove as part of its prima facie case that the credit card payment is property of the estate.

F. Vendor May not be Free from Challenge

While the *Perry* ruling is welcome news for vendors fighting a preference, the vendor's potential liability may not end with dismissal of the preference suit. The court noted the injustice to the card company, as it was substituted as a creditor with the vendor. While the bankruptcy court would not address whether the card company may charge back the transaction to the vendor, the door was opened.

G. The Lesson for Credit Executives

The *Perry* court's ruling encourages vendors dealing with financially-strapped customers to consider payment by credit card, especially if the vendor senses that the customer may be forced to file bankruptcy. The court's refusal to find that a credit card

(*Continued on page 14*)

IMMUNIZING PAYMENTS FROM PREFERENCE RISK: THE CREDIT CARD DEFENSE?

(Continued from page 13)

payment constituted property of estate, encourages vendors to continue to sell to customers in financial difficulty.

A vendor must address a number of issues prior to accepting credit cards, such as the terms of the merchant contract, credit card software, processing the card, timing of shipments with credit card payments, fraud, privacy issues, chargebacks and the costs of the transaction. However, as noted, accepting credit cards has many advantages, including, now, a potential preference defense.

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2. 343 B.R. 685 (Bankr. D. Utah 2005)

3. 343 B.R. at 688.

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