Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

Fall 2007
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Developments in Commercial, Creditors' Rights, E-Commerce, and Bankruptcy Law of Interest to the Credit and Financial Professional

YOU'VE BEEN SELECTED AS A CRITICAL VENDOR (YES!), BUT CAN YOU INCREASE YOUR PRICES POSTPETITION?

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Evaluating credit risk of a customer with a complex balance sheet and varied sources of revenue, can, at times be a science for the credit executive. Attempting to evaluate a customer's insolvency risk, or forecast that risk, may often requires the credit judgment of a seasoned credit executive, which can make the difference as to whether a vendor acts early and cuts off future credit. However, even if the insolvency risk is identified, a vendor may still elect to extend terms where a customer is a significant source of business, and management may override the credit executive's credit hold recommendation. In this setting, management believes that the opportunity for profit through short term sales may outweigh the customer's insolvency risk.

If the customer does file Chapter 11, the credit executive knows that long delays await 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 prepetition claim. Traditionally, a vendor's collection strategy for the chapter 11 customer was limited to filing a proof of claim, perhaps serving on the creditors' committee, and in serving on the creditors' committee, press the debtor for a meaningful payment. However, with the evolution of the critical vendor doctrine, the credit executive may have an alternative for payment that may result in payment in full.

The critical vendor doctrine most commonly applies where a vendor is a key supplier. 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.

What points does the credit executive negotiate with the debtor before committing to a critical vendor contract? How long must the vendor continue to supply the vendor to qualify? What of price increases? What is the consequence if one of the provisions is breached, must the vendor disgorge the critical vendor payment? The bankruptcy court in *In re Meridian Automotive Systems* recently considered the terms of a critical vendor contract and whether the vendor may pass on price increases to the debtor postpetition. Unfortunately, for the vendor, not only did the court not allow the vendor pass on the price increases, but

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IS A DEBTOR'S CREDIT CARD PAYMENT TO YOU A PREFERENTIAL TRANSFER? IT ALL DEPENDS

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When making credit arrangements with a struggling debtor, a creditor should give special consideration to receiving payment by credit card. As determined by the Kansas bankruptcy court in the recent decision of *In re Bryan K. Marshall*, a transfer by a debtor's credit card company may not be considered a preferential transfer in the event the debtor files bankruptcy.

In *In re Bryan K. Marshall*, the Chapter 7 trustee brought an adversary proceeding to set aside alleged preferential transfers occurring when the debtors took advantage of offer by one credit card company to transfer balances from the debtors' other credit card accounts. The creditor defended on basis that, when balance was paid by the credit card company, no interest of the debtors in the property was transferred as required under the bankruptcy preference laws.

Before the payments by the credit card company to the creditor, the debtors had available pursuant to their agreements with the credit card company two substantial lines of credit. Pursuant to the debtors' request, the credit card company transferred funds to the creditor and posted as balances due from the debtors to the credit card company in the amounts paid to the creditor. Before the transactions, the debtors owed the creditor, and after the transactions, the debtors' obligation to the creditor was re-

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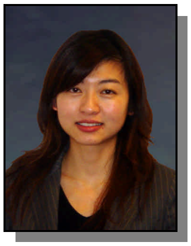
PAYMENTS MADE IN ORDINARY COURSE OF BUSINESS BASED ON THE TIMING OF THE CAPITAL INFUSIONS DESPITE LITTLE CONSISTENCY IN THE TIMING AND AMOUNT OF THE PAYMENTS



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Vendors often raise an ordinary course of business defense in defending a preference action to show that the alleged preferential transfers were made in consistent with the transactions prior to the preference period and were made in the ordinary course of business between the debtor and the vendor.

When determining whether a transfer is made in the ordinary course of business, courts look at the delay in payment and the age of the paid invoices when paid as important factors. However, in *In re NETtel Corporation, Inc.*, 369 B.R. 50 (2007), the court focuses on the debtor's cash infusions from its investors as the determining factors to the timing and amount of the payments. When the amount and timing of the debtor's payments were never tied to the age of the invoices issued by the creditor, the age of those invoices at the time of payment is irrelevant.

In *NETtel*, the Chapter 7 Trustee filed a preference action to recover two transfers made by NETtel Corporation, Inc. ("NETtel") to DMR Consulting, Inc. ("DMR"), a service provider. NETtel never made any of its payments within thirty days of receipt of the invoices as provided by the terms of the parties' contract.

In December, NETtel's operations were substantially funded by a large infusion of working capital received in the prior summer. By the following February, NETtel was paying only a portion of its bills because its cash position had worsened. NETtel's routine response was to ask the vendors to be patient and to indicate that NETtel was expecting a substantial infusion of working capital from its IPO, at which time NETtel would be in a position to make substantial payments to its vendors on their past-due invoices.

FROM THE PUBLISHER:

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In early April, NETtel received an infusion of approximately $6 million. The loan enabled NETtel to make significant payments to its vendors, including DMR. On April 20, NETtel received an infusion of approximately $10 million from a private placement in which NETtel issued shares of preferred stock to a group of investors. An additional infusion of $1.5 million in May contributed to smaller payments to NETtel's vendors. NETtel received a $14 million cash infusion in July, and another $10 million in August.

The infusions resulted in payments during the preference period to DMR. The Trustee seeks to avoid the last two payments as preferential transfers. DMR argued that the two payments at issue were made in the ordinary course of business pursuant to 11 U.S.C. section 547(c)(2), prior to the 2005 Bankruptcy Reform Act.

The court determined that NETtel's payments appeared to be little consistency prior to the preference period. NETtel argued that the timing of payments by NETtel to its vendors was directly related to the timing of infusions of funding from NETtel's investors and lenders. The amount of payments made by NETtel to its vendors was directly related to the availability of funding from such infusions and to NETtel's ordinary practice of paying its vendors

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PACA: PROTECTIONS FOR AMERICA'S AGRICULTURAL ROOTS IN THE 21ST CENTURY

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As the millennium presses on, Americans grow further and further from the agrarian roots that form the genesis of our modern economic might. Farming, privately and commercially, no longer occupies the political ear it once did. However, agriculture continues to hold a position as one of America's great assets. An issue that farmers and the sellers of their produce face is ensuring that the law, with its organic and ever-changing nature, continues to protect their interests politically and monetarily. Enter the Perishable Agricultural Commodities Act, better known by the acronym PACA.

PACA was established by Congress to protect the sellers of produce from nonpayment by the buyers of their goods. One of the more important aspects of PACA is a provision that allows for the creation of a trust. PACA allows for the preservation of a seller's interest in produce sold through the creation of these trusts. These trusts are a crucial part of PACA in that, when properly created, if a buyer of produce subject to the trust becomes insolvent, the proceeds held in the trust are given to the seller before any other creditors are paid any of the assets that make up the trust.

If a trust is correctly created under PACA, the produce and monies gained through the sale of the produce must be kept separate from a buyer's produce and monies not subject to the trust. Failure to keep trust goods and monies separate from all other goods and monies allows the seller to reach any of the buyer's assets to satisfy the debt of the trust.

To create a trust under PACA, the first requirement is that notice be given by the seller to the buyer of the intent to create the trust within 30 days of the debt becoming due. PACA allows this notice requirement to be satisfied by including a specified statement in the billing papers. This statement is located on PACA's website and brochures available through the mail from PACA. As long as this notice is given, the seller's interest in the trust is solidified.

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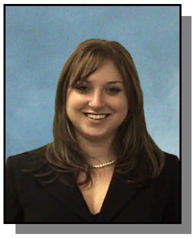
HOLDING A GUARANTOR LIABLE THIRTY YEARS LATER



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When it comes to starting a new business, purchasing equipment, or raising capital for an existing business, the subject of guaranties frequently comes into play. It is not uncommon in today's business practices for vendors extending credit to customers to request that the customer execute some form of guaranty. But when exactly does the guarantor's obligation to the vendor cease?

In a recent Federal District Court decision, the court in Phelps Dodge Corp. v. Schumacher Electric Corp., 415 F. 3d 665 (N.D. Ill. 2005) held a guarantor liable for the debtor's failure to pay it's creditor thirty years after the guarantor executed the guaranty.

Schumacher Electric ("Schumacher") was a family owned corporation that engaged in the manufacture of battery charging equipment and electrical transformers. A major component of Schumacher's business involved the use of copper wire. In 1968, Schumacher's principal created Horning Wire Corporation ("Horning") to manufacture the required copper wire for Schumacher. Phelps Dodge ("Phelps") then sold the copper rod required for the manufacture of the copper wire to Schumacher, but delivered the copper rod to Horning at Schumacher's request. In 1971, at Schumacher's request, Phelps began to sell the copper rod directly to Horning, for which Horning was responsible for payment. In order to induce Phelps to become a trade vendor of a new company such as Horning, Schumacher entered into the following guaranty, "…in connection with our request to Phelps to sell, and therefore bill Horning rather than Schumacher, this letter will serve as a guaranty by Schumacher of the payment of any purchases of copper by Horning from Phelps."

Thirty years after the execution of the guaranty, Horning was unable to keep up with its bills and defaulted on its account with Phelps in the amount of $372,000. Phelps sought to hold Schumacher liable on its guaranty, which Schumacher refused, explaining that it had not kept a copy of the guaranty and had forgotten of its existence.

In the ensuing litigation, between Phelps and Schumacher for enforcement of the guaranty, Schumacher argued that when a guaranty is silent as to duration, the guarantor's obligation to pay for the debts of the debtor should expire after a "reasonable time."

In formulating its decision, the court relied on basic contract interpretation principles and acknowledged that contracting parties would unlikely place themselves in situations that would extend their obligations "until the Day of Judgment." However, the court cited that such a legal principal has limited application to continuing guaranties, the type of guaranty executed between the parties.

A continuing guaranty is one that is tied to a specific course of dealing between the parties and is revocable at any time by the guarantor upon notice to the obligee without any liability. Thus, a continuing guaranty protects a party from being placed under an obligation of oppressive duration. The only situations in which the law imposes time limits on continuing guaranties is where the course of dealing to which the guaranty was tied have ceased, the guarantor reasonably assumes that the guaranty has lapsed, and later discovers that the parties resume their course of dealings.

The situation between Phelps and Horning however was a continuous relationship which never lapsed. Phelps, aware of its ability to recover if necessary from Horning's guarantor, supplied Horning with its required amount of copper. Schumacher at no point made any attempt to revoke the guaranty, even though it could have done so at any time.

The court was unwilling to supply a "reasonable time" for the expiration of the guaranty in this case as the guaranty and the language surrounding the obligation was sparse, thereby making it more difficult for the court to step in and devise terms to fill in the gaps. Given the simplicity of the remedy associated with continuing guaranties; revocation at any time without liability, the court held Schumacher liable for the debts of Horning to Phelps.

When negotiating the relevant provisions of a guaranty, the trade vendor should

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VOICE MAIL REQUESTING PAYMENT VIOLATES THE AUTOMATIC STAY—AND WARRANTS PUNITIVE DAMAGES

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You receive notice that your long term customer, a sole proprietor, that you have provided product or service on credit has filed for Chapter 11 or Chapter 13 bankruptcy. The bankruptcy filing leaves you with a prepetition unsecured claim. You had a long trade relationship with the debtor and routinely followed up delinquent invoices with reminder phone calls. The phone calls generally were effective in getting the invoices paid.

A credit executive is well aware that with a bankruptcy filing, whether a Chapter 7, 11 or 13 bankruptcy petition, whether an individual, partnership, corporation or LLC have filed, all collection efforts must immediately cease because of the automatic stay. But does your calling the debtor regarding your prepetition debt constitute a violation of the Bankruptcy Code's automatic stay, especially when you have a continuing trade relationship with the debtor postbankruptcy? What if you leave a voice mail that you may turn the delinquent account over to the local district attorney to investigate any criminal wrongdoing as to the prepetition debt, as the debtor passed "NSF" check, violate the automatic stay, and even lead to punitive damages? In a recent bankruptcy case, *In re Hodge*, the court found the creditor's voice mail had violated the automatic stay and awarded sanctions to the debtor.

Creditor's Voice Mail Demanding Payment

In *Hodge*, a creditor held an unsecured claim against the debtor prebankruptcy. The debtor filed Chapter 13 bankruptcy. The creditor received written notice from the debtor's counsel on the date of the bankruptcy filing that the debtor had filed and that the automatic stay was in effect.

After receiving the letter from the debtor, the creditor left a voice mail demanding the debtor repay the prepetition debt which was based on an "NSF" check.

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CASHING CHECK NOTATED "PAID IN FULL": ARE YOU WALKING FROM THE BALANCE OWED?

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Customers are continuing to push vendors towards electronic forms of payments, and vendors are embracing (some forced) such forms of payments. However, a customer paying by check is still the most common method of payment for a vendor's goods or services. Given this, a vendor must still be mindful of the informal means of a customer resolving disputes through payment by check, referred to as accord and satisfaction.

Consider the common situation in a non-electronic form of payment: you invoice the customer $125,000 on open account. When payment is due, your customer disputes the amount of the open invoice, contending that, say, only $100,000 is owed based on defective product included in the shipment. Your customer mails a check to your credit department for $110,000 in an attempt to resolve the dispute. The debtor writes on the check "payment in full." What are the consequences if you cash the check? Do you waive the right to the balance of the open invoice?

A recent opinion, *Wolfe Construction v. Eagle Ridge*, discusses the legal principle of "accord and satisfaction"; how a debtor and creditor may rewrite a contract to settle an account dispute without court intervention.

Accord And Satisfaction

Accord and satisfaction is generally defined as a substitute contract between a debtor and creditor for the settlement of a debt for a different amount than allegedly owed. Accord and satisfaction has evolved from common law principles that encourage parties to settle a disputed debt without judicial intervention.

Under the common law, if a creditor received a check for less than the full amount owed and that check contained a conspicuous notation that it was tendered as satisfaction of the entire debt, the creditor had two options: (1) reject the offer by returning or destroying the check; or (2) cash the check and accept the accord. A creditor can not avoid an accord and satisfaction by either reserving his or her rights by writing on the check or by crossing out the full settlement language on the check.

The Uniform Commercial Code (UCC) codified the common law, with some variations to reflect modern business practices. Section 3-311 of the UCC specifically deals with accord and satisfaction in the commercial marketplace. Certain states have overlapping accord and satisfaction provisions in their UCC and state statutes.

The "accord" is the agreement between the parties to accept something less than the amount one party contends is owed. The "satisfaction" is the execution of the agreement, and the vendor depositing the check, which extinguishes the obligation.

Under the UCC, before an accord and satisfaction can be established, there must be a bona fide dispute between the parties. To determine whether a bona fide dispute exists, the general test is whether the dispute was in good faith. Ordinarily, the customer must generally prove that they acted in good faith in tendering an instrument as full satisfaction of a claim. Thus, there must be an honest dispute between the parties as to the amount due at the time payment was tendered. When a party is acting dishonestly as to the dispute, they will not meet the good faith test. A debtor's open refusal to pay a debt is not enough to establish a good faith dispute. But, rather, the debtor must demonstrate a just basis for refusing to pay.

Before a check can create an accord and satisfaction, the party who presents the check must make clear, by conspicuous wording, that cashing the check will be construed as settlement of all outstanding claims between the parties. Such notation can take the form of a debtor writing on the check, or accompanying voucher: "Payment in full settlement of the stated accounts" or "Endorsement of the check constitutes a complete settlement of your claim" in conspicuous letters.

Under the UCC, a party may avoid an accord and satisfaction by returning the money within ninety days. A party's bid to prevent a satisfaction by accepting the check but scratching out the restrictive endorsement and adding the words "without prejudice" is of no avail. Under the UCC, words of protest cannot change the legal effect of an accord and satisfaction once a check has been cashed.

The UCC provides for prevention of an accord and satisfaction mistakenly taking place. Where a check is sent to an automated collection center of an organization and are cashed without inspection, a vendor may require that, to be effective, any attempted accord and satisfaction must be sent to a particular office.

Accord And Satisfaction In Action

In *Wolfe Construction v. Eagle Ridge*, the debtor contracted with the vendor to construct a building. After completion of the work, the vendor sent the debtor a final invoice. The debtor sent a check, with the words written on both the front and back of the check "Full & Final Payment." The check was accompanied by a "Debit Memorandum". The vendor did not immediately cash the check, but instead filed a notice of intention to hold a mechanic's lien against the real estate. The vendor then attempted to cash the check, but the debtor's bank refused to cash the check as it was more than six months old.

The debtor sent the vendor a replacement check which was also marked on the front and back, "Full & Final Payment." The vendor endorsed and cashed the check. The debtor demanded the vendor release the mechanic's lien. The vendor refused to release the lien and filed a complaint to foreclose the mechanic's lien. The debtor filed a counterclaim alleging that it suffered damages because of vendor's refusal to release the lien. The trial court entered judgment in favor of the debtor finding an accord and satisfaction, and the vendor appealed.

The General Rule

The court analyzed the checks, and found that the notations on the checks were conspicuous and that the vendor understood that the checks were meant to fully satisfy the debt. Accordingly, the debtor argued, there was an accord and satisfaction of the debts. The court cited the general rule under the Uniform Commercial Code that where an amount due is in dispute, and the debtor sends a check for less than the amount claimed, expressing a settlement in full, the cashing of the check will be held as an acceptance of the customer's offer.

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PAYMENTS MADE IN ORDINARY COURSE OF BUSINESS BASED ON THE TIMING OF THE CAPITAL INFUSIONS DESPITE LITTLE CONSISTENCY IN THE TIMING AND AMOUNT OF THE PAYMENTS

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some portion of the total amount it owed based on what NETtel could reasonably afford to pay.

While NETtel's payments varied in terms of size, number of invoices covered, and length of time from issuance of a particular invoice to that invoice's payment, the court concluded that the payments corresponded roughly to the dates and amounts of infusion from NETtel's lenders and investors. Payments were not made in response to specific overdue invoices, but rather were made to satisfy a "reasonable proportion of the total payable balance" owed to each vendor depending on the size of the infusion.

Furthermore, DMR merely inquired as to the status of its payment. NETtel responded with a payment plan consistent with its pre-preference period practice of making significant payments of its invoices upon receiving capital infusions. NETtel merely followed that practice as it had planned all along.

Given that NETtel and DMR looked to infusions of capital as controlling both the timing and amount of payments, the court concluded that when the timing and amount of payments were based on the timing of the capital contributions, and the creditor brought no unusual collection efforts to bear on the debtor during the preference period, the preference period payments were in the ordinary course of the parties' business affairs.

Although the court in this case looks at the timing of the capital contributions instead of the timing of the payments prior to the preference period, the underlying factor in determining an ordinary course of business defense is identical, in which courts have repeatedly held that vendors' collection practice needs to be consistent throughout the business relationship. A vendor should reduce the risk of preference exposure by keeping the preference period practice consistent with the pre-preference period practice.

PACA: PROTECTIONS FOR AMERICA'S AGRICULTURAL ROOTS IN THE 21ST CENTURY

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Buyers of produce can find themselves in a pinch when PACA is applied by the courts. In a recent case, *A.J. Rinella & Co., Inc. v. Bartlett*, a seller of fruits and vegetables sold thousands of dollars worth of their goods to a buyer over a five month period. That debt was never paid, and it appears that a PACA trust was never created. Subsequently, the buyer sold more goods to the buyer over a four month period. After the four month period, the buyer informed the seller that they were closing their doors. The buyer made payments contemporaneously with the second set of shipments, which they argued were for payment of those goods, not the earlier set of shipments. The seller however properly created a PACA trust on the later shipment of goods when it learned of the buyer's financial woes. The buyer claimed that the monies paid for the second shipment was to cover the PACA trust goods, and the earlier shipment was a debt that, without a properly created PACA trust, would be discharged under the pending bankruptcy.

The Court sided with the seller, and allowed it to apply the payments to the prior debt. Thus, the prior debt became paid, and the PACA trust remained intact and unpaid, and therefore the seller had a right to payment out of either the trust assets if any were available, or other assets if commingling occurred. It goes without saying that it would behoove sellers to ensure that their produce is protected by a PACA trust. But the larger lesson of this case is that buyers should ensure that there is a clear writing that describes the goods being paid for. If a past debt is due, the courts may very well consider any later payments as a satisfaction of those prior debts to allow the application of a PACA trust to later accrued debt when no writing specifies otherwise.

PACA is a growing area of the law, and buyers of produce should be very aware of the changes that are made. As the case above illustrates, courts can apply PACA in ways not originally imagined by Congress when the law was passed. With the uncertainty of the courts under PACA, buyers must ensure proper memorialization of transactions that fall within PACA's authority, and take all steps to keep abreast of rulings made by courts on the subject.

CASHING CHECK NOTATED "PAID IN FULL": ARE YOU WALKING FROM THE BALANCE OWED?

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Good Faith Dispute

A good faith dispute between the parties is a prerequisite to an accord and satisfaction. The court observed that the debtor had expressed its good faith dispute through its debit memo. The court found that in this case, there was an honest dispute between the debtor and the vendor when the debtor tendered the checks to the vendor.

Clearly Intend to Settle Dispute

The customer's checks plainly stated an intention to compromise the disputed balance, and the debit memo referenced a number of problems with the vendor's services. The court ruled that the debtor had made it clear that depositing the check would settle all outstanding disputes.

Lesson Learned

The court's opinion in *Wolfe Construction* reminds vendors that an accord and satisfaction may be effected where a debtor makes clear that issuing the check is intended to settle the outstanding claim between the parties and that the vendor, by cashing the check, accepts the settlement. A customer's notation on the check, or accompanying voucher, can take a number of forms, such: "Payment in full settlement of the stated accounts" or "Endorsement of the check constitutes a complete settlement of your claim" in conspicuous letters. It should be noted that a vendor crossing out the restrictive endorsement and adding the words "without prejudice" or "under protest" will not defeat an accord and satisfaction, as the U.C.C. provides that words of protest cannot change the legal effect of an accord and satisfaction.

VOICE MAIL REQUESTING PAYMENT VIOLATES THE AUTOMATIC STAY—AND WARRANTS PUNITIVE DAMAGES

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The creditor also suggested that she had spoken with the local district attorney, and threatened the debtor with arrest and criminal prosecution if the debt was not repaid. The debtor claimed that upon hearing the creditor's voice mail, and feared would be arrested.

Debtor Claims Damages For Violation Of Stay

The debtor contended that the creditor willfully violated the automatic stay by leaving the voice mail after knowing of the bankruptcy filing, thereby attempting to collect on its prepetition debt. Because the debtor was an individual, the debtor requested that the bankruptcy court assess actual damages, including attorneys' fees and punitive damages against the creditor.

The Automatic Stay: Anything Worth Doing Is Stayed

The automatic stay is an injunction which automatically and immediately goes into effect as soon as a bankruptcy case is filed, whether the bankruptcy filing is one under Chapter 7, 11 or 13, and whether the case is commenced as an involuntary bankruptcy. The stay is automatic in the sense that it arises automatically upon filing the bankruptcy case by operation of law, without the bankruptcy court having to enter an order stating that it exists. The stay is in effect even where the creditor has not been given notice that the bankruptcy case has been filed.

The automatic stay prohibits any creditor from taking action against the property of the estate and against the debtor, unless relief from 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 stay also enjoins secured creditors from repossessing or selling collateral.

The purpose of the automatic stay is to give the debtor breathing room, and to protect creditors from each other by preserving the bankruptcy estate intact until property can be distributed according to the bankruptcy priority scheme and allow orderly administration of the case. The scope of the automatic stay is so broad that any action to collect is probably stayed. The debtor cannot modify the stay without the bankruptcy court modifying the stay and creditors having the opportunity to comment.

Damages are assessed against a creditor only where it is shown that the creditor had notice or knowledge of the bankruptcy filing. Where there is a willful violation of the stay, the court will award a debtor actual damages, including a debtor's attorney's fees and costs for enforcing the violation. The court may also award punitive damages to punish the creditor.

Creditor's Voice Mail Violates the Stay and Merits Punitive Damages

As a starting point, the bankruptcy court found that creditor, through its representative, was aware of the debtor's bankruptcy and the automatic stay when the voice mail was left. The court observed that the phone call and voice mail was an act to collect a prepetition debt. Therefore, the creditor, through its employee, willfully violated the automatic stay. For this violation of the automatic stay, the debtor sought damages in the form of attorney's fees of several thousand dollars in responding to the voice mail. The court agreed and found the attorney's fees were necessary to protect the debtor's interests.

The court then considered whether punitive damages should be awarded to the debtor for the creditor's violation of the automatic stay. The court found that using any standard, punitive damages were appropriate given the creditor's threat to have the debtor arrested and criminally prosecuted was wrongful. The court observed that under the state's bad check laws, the debtor could not be prosecuted criminally. Thus, the creditor's action was malicious and vindictive, as the language in the voice mail conveyed a getting even with the debtor, through arrest, for failing to repay the debt. The creditor's conduct was motivated to coerce the debtor into paying the debt outside of the bankruptcy proceeding.

Communicating with the Debtor Postbankruptcy

The *Hodge* court reminds a credit executive that attempts to communicate with the debtor postbankruptcy regarding your prepetition claim may be viewed as pressuring the debtor to pay the prepetition claim, thereby violating the automatic stay. Although it is understandable to be frustrated with a debtor attempting to walk from your prepetition debt through a bankruptcy filing especially if you have received an "NSF" check, the *Hodge* court highlights the risk of a creditor attempting to even the score with a false threat of criminal prosecution, especially in an effort to force payment on a prepetition debt. Remember, bankruptcy courts regard the automatic stay as a fundamental protection for the debtor and a primary reason for a debtor filing bankruptcy. A vendor that knowingly violates the automatic stay by pressuring the debtor to pay prepetition delinquent account risks sanctions by a bankruptcy court.

HOLDING A GUARANTOR LIABLE THIRTY YEARS LATER

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consider whether a continuing guaranty is in the best interest of the vendor. If the vendor does chose to have its customer execute a continuing guaranty, consider the ability of the customer to revoke the guaranty at any time, potentially leaving the vendor with no remedy against the guarantor. Additionally, vendors should keep adequate records of any continuing guaranties is executes with its customers in conjunction with business records so that a solid course of dealing may be established in the event of the default of a remotely executed guaranty. On the other hand, a guaranty with a termination date may require the vendor to re-execute a subsequent guaranty with its customer, necessitating the renegotiation of the guaranty's terms, which may give the customer greater leverage with respect to the terms of the guaranty and less protection to the vendor.

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the court ruled that the vendor had breached the critical vendor contract and must disgorge the $1.2 million critical vendor payment.

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 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 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 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. Under this 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.

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 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.

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. However, where a 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, in limited circumstances courts have given critical vendor status to vendors that are parties to executory contracts.

B. Vendor Given Critical Vendor Status, But Watch for Strings Attached

In *In re Meridian*, the debtor supplied an auto manufacturer, and the vendor provided the debtor with specialized tooling. The debtor filed Chapter 11, and part of its first day filings was a motion requesting critical vendor status of certain vendors. The debtor selected the vendor as a critical vendor and the parties entered into a Trade Agreement. As part of the critical vendor court order, the debtor paid the vendor $1.25 million on account of its prepetition claim.

After signing the Trade Agreement and committing to provide specialized tooling postpetition, the vendor advised the debtor that it would not continue to provide service parts. The debtor objected, contending that the Trade Agreement and critical vendor court order obligated it to do so. The vendor twice demanded price increases for the service parts, a 200% price increase and a 50% price increase, respectively. When the debtor rejected the vendor's demands for price increases, the vendor did not ship any service parts for a couple of months. As a compromise to resolve the postpetition trade dispute, the vendor agreed to transfer to the debtor all the tooling necessary to manufacture the service parts.

The debtor demanded the vendor repay the $1.25 critical vendor payment because of its failure to abide by the terms of the Trade Agreement. When the vendor refused, the debtor requested the bankruptcy court order disgorgement of the critical vendor payment. The bankruptcy court considered whether the vendor had breached the Trade Agreement, and, accordingly must repay the critical vendor payment. The *Meridian* court's decision is considered below.

1. Demands for Price Increase

The threshold issue for the court was whether the vendor abided by the parties' Customary Trade Terms, or instead wrongfully demanded price increases which violated the Trade Agreement and Critical Vendor Orders. The vendor argued that neither the Trade Agreement nor Critical Vendor Orders expressly stated the actual price at which the product was to be sold, or that prices could not be renegotiated. The *Meridian* court disagreed and found that the vendor's request for a price increase was exactly what the Trade Agreement and Critical Vendor Orders sought to bar.

2. Vendor's Refusal to Deliver

The debtor noted that when the vendor refused its request for a price decrease, it did not refuse to pay the vendor for those purchase orders at the reduced price. The vendor contended that it was not required to deliver any product, because under the parties' Customary Trade Terms the vendor had no obligation to fulfill any purchase

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order until the parties had resolved the price dispute. The *Meridian* court found that the vendor's refusal to ship product was a violation of the Trade Agreement and Critical Vendor Orders, which the vendor did not cure.

3. Subsequent Failures to Deliver

The debtor contended that even ignoring the vendor's refusal to ship, the vendor subsequently continued to violate the parties' prepetition Customary Trade Terms. The vendor argued that it was unable to supply all parts ordered by the debtor because it requested a significantly greater number of parts from the vendor. The *Meridian* court found that the vendor did not perform its obligations under the Trade Agreement and Critical Vendor Orders, the vendor did not have a valid excuse for its failure to perform. The *Meridian* court also found that the evidence did not show a significant increase in orders by the debtor during the disputed period.

4. Termination of Trade Agreement

The vendor argued, however, that the debtor was not entitled to repayment of the $1.25 million critical vendor payment, because the debtor was required to terminate the Trade Agreement before it could recover the critical vendor payment. The *Meridian* court rejected the vendor's argument for two reasons. First, the Critical Vendor Orders provided two instances under which vendor could be required to return the critical vendor payment: (1) where its participation is terminated on notice from the debtor, or (2) where it refuses to supply goods in accordance with the parties' Customary Trade Terms. The *Meridian* court concluded that the debtor did terminate the Trade Agreement with the vendor in accordance with the terms of the Trade Agreement and the Critical Vendor Orders and the vendor was, accordingly, required to return the critical vendor payment.

5. Assumption of Executory Contract

In attempt to block turnover of the critical vendor payment, the vendor also argued that the supply agreement the parties had operated under prepetition was an installment agreement under the Uniform Commercial Code, which was executory under section 365 of the Bankruptcy Code. Under this theory, the vendor argued that if the contract was assumed there would be no disgorgement of the critical vendor payment as the executory contract was assumed, which requires the prepetition delinquent account be cured. The *Meridian* court agreed with debtor's contention that there was no contract to be assumed, as there remained no material obligation owed by either party under the prepetition supply agreement.

6. Pre-Judgment Interest

The *Meridian* court granted the debtor's request for prejudgment interest which accrued from the date the debtor had demanded the vendor turnover the critical vendor payment.

C. Reminders for the Critical Vendor in Committing to the Trade Agreement

As shown by the *Meridian* court, the postpetition vendor agreement or Trade Agreement will control the terms of sale between the debtor and you, including, among other items, controlling your right to pass on price increases. Given the harsh result forced on the vendor in *In re Meridian*, what are some of the key terms that you need to be mindful of?

1. How Much Are You Getting Paid?

The critical vendor doctrine has evolved from the debtor requesting a particular vendor be paid immediately, to the debtor requesting a class of vendors qualify as critical vendors, to the debtor now often requesting the bankruptcy court establish a critical vendor "trade claims cap". This means that it is possible you may only be paid a percentage of your prepetition debt, yet still be required to commit to comparable trade terms postpetition, as in *In re Meridian*. In this setting, the debtor does not propose to pay in full each vendor deemed critical, but only the minimum for you to continue selling on credit. You need to confirm the critical vendor motion and order as to whether you will be paid in full.

2. Postpetition Commitment: Customary Trade Terms

In exchange for being deemed critical and payment on all or some of the prepetition debt, you will be required to agree to a Trade Agreement which will control your rights postpetition. The Trade Agreement commonly requires you to provide the debtor Customary Trade Terms which usually means the most favorable terms that have been offered the customer prepetition. As in *In re Meridian*, the debtor may attempt to lock you into a fixed price for a substantial period.

a. Credit Terms

What are the postpetition credit terms the debtor requires you to commit to qualify as a critical vendor? The Trade Agreement commonly requires you to provide the most favorable terms offered the debtor in the six months preceding the bankruptcy. This means those favorable credit terms did not reflect insolvency risk.

Recent Trade Agreements approved by bankruptcy 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 you to terminate the trade relationship should the debtor fail to pay according to the credit terms, you should insist such a provision be added. Further, you may want to include a provision that allows you 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 you to hold orders in the face of a debtor's deteriorating postpetition financial operations.

b. Price Increases

As shown in *In re Meridian*, a Trade Agreement may lock you into a fixed price for your product or service, and not allow you to increase price based on changes in market conditions, including your costs of raw materials. This provision can be especially detrimental should you commit to an open-ended term.

c. Volume of Product or Services

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What is the volume of goods are services that you are committing to postpetition on credit? The Trade Agreement should specify the amounts that will be provided on credit terms. If you do not have this agreed to, you may find yourself like the vendor in *Meridian* complaining about the amount you are committed to providing on credit.

d. Length of Postpetition Trade Commitment

How long are you committing to provide your product or service? Through confirmation of the plan of reorganization? Post confirmation? As in *In re Meridian*, vendors are committing, perhaps unknowingly, to long term sales contracts, with extended credit terms, in exchange for payment on their prepetition claims (in some instances, payment on only a portion of the prepetition debt). 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.

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 your critical vendor payment? How do you get paid on the delinquent invoices? This should be set out in either the Trade Agreement or critical vendor order.

4. Postpetition Credit Risk

You need to ensure that your postpetition credit does not exceed your prepetition debt, unless comfortable with the credit risk. For example, you may have a nominal pre-bankruptcy balance, yet the debtor is entering their selling season, and therefore under the terms of Trade Agreement, you may have committed to 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. 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. You should negotiate immediate payment for the full amount, if possible.

F. Examine Trade Agreement Before Committing to Critical Vendor Status

A vendor being deemed a critical vendor can have a dramatic impact on the account. The credit executive is not forced to wait on what may turn out years for a speculative percentage payment from a reorganizing debtor. The debtor and its vendors benefit by receiving needed product or service on credit, which may assist in leading to a successful reorganization. However, *In re Meridian* reminds the vendor that a Trade Agreement is a new commitment postpetition which may require a long term commitment, with burdensome terms and unanticipated credit risk. The Trade Agreement must be scrutinized to determine whether there are onerous terms, and whether those terms outweigh the risk of the benefits of being deemed a critical vendor.

IS A DEBTOR'S CREDIT CARD PAYMENT TO YOU A PREFERENTIAL TRANSFER? IT ALL DEPENDS

(***Continued from page 1***)

duced and their liability to the credit card company increased by the same amount. In effect, there was a substitution of creditors.

As a result, the primary issue before the *Marshall* court was whether the transactions constituted a transfer of an interest of the debtors in the property. The court defined a preferential transfer as property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings, and found that the fundamental inquiry is whether the debtor had a legal or equitable interest in the property transferred such that the transfer at issue diminished or depleted the debtor's estate. The court reasoned that the recovery of interests in property of the debtor serves the purpose of protecting against the dismemberment of the debtor and promotes equality of distribution to creditors. Based on this rationale, the *Marshall* court found by drawing on the line of credit with the credit card company, the Debtor merely substituted one creditor for another and did not diminish property available to their creditors.

The *Marshall* court recognized, however, that its opinion is the minority view. The court acknowledged a number of cases whereby courts considered whether the creditor had an earmarking defense to the action. "Earmarking" is a judicially-created doctrine said to apply when a new creditor pays a debtor's existing debt to an old creditor. However, most courts limit the earmarking doctrine to cases where the new creditor has control over disposition of the loan proceeds. In the *Marshall* case, the debtor had control over the disposition of the loan proceeds and the earmarking doctrine would therefore not apply.

In the recent case of *In re Warner* from the Middle District of Georgia, the bankruptcy court similarly found that if the debtor decides which creditor is paid, the proceeds are not earmarked by the new lender for repayment of the existing loan, and thus, the proceeds constitute an interest of the debtor in property avoidable under the preference law. In *Warner*, the debtor

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could have distributed the funds among of his creditors, but he instead transferred them to one select creditor. The court found that the debtor initiated and directed the transfer of funds from his credit card account to the creditor, which he could not have done if he had no interest in the funds. Accordingly, the court found that there was no reason to distinguish this scenario from one in which a debtor obtains a cash advance and uses the advance to pay one of many creditors. Consequently, the court concluded the transfer was of an interest of the debtor in property.

In examining the majority view, the Marshall court found that theoretical possibility that a debtor can draw upon a line of credit for any purpose is not sufficient to find the debtor has a property interest in credit proceeds that at debtor's direction are paid directly to a specific creditor. In the end, the *Marshall* court found that a debtor's line of credit is not an asset available to increase the property available for the payment to creditors, and the reasoning for the majority decisions wrongfully focuses on what the debtor could have done rather than what he did do.

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