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THE TRADE VENDOR QUARTERLY

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

DOCUMENTING YOUR CREDIT SALE TO THE FINANCIALLY DISTRESSED CUSTOMER:

Can A Supply Contract Get You Paid And Avoid Preference Risk If Your Customer Files Chapter 11?

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A vendor may sell its customer on an invoice by invoice basis, or commit to a supply of its product or service over a period of time or duration of a project under a supply contract. The method in which the vendor is selling the customer has particular significance during the recession, especially given the number of customers resorting to chapter 11 to attempt to resolve their financial difficulties, and in particular using the asset sale provision of the Bankruptcy Code for an early exit from chapter 11.

Headlines of major companies rushing to sell their assets while discarding liabilities in the opening weeks of chapter 11 (Chrysler selling to Fiat in 42 days and GM selling itself to "new GM" in 60 days), as well as prepackaged plans are now common for these customers to attempt to exit Chapter 11 in record time. What do these recent developments mean to the vendor in evaluating credit risk and sale alternatives, especially during a recession?

The Sales Mantra: Maintain Market Share in a Down Market

With the downturn in the economy, vendors are struggling to meet their sales objectives. From the credit professional's perspective, credit evaluation requires a more flexible approach as management is likely willing to increase credit risk to attempt to achieve market share. The credit professional is much more a relationship builder in this marketplace, attempting to accommodate the sale's objectives, rather than merely serving as a gatekeeper to the vendor's unsecured credit.

In this setting, may the method in which the vendor sells the customer, whether invoice by invoice vs. supply contract, better achieve management's objectives

Selling Invoice by Invoice vs. A Supply Contract

Under an invoice by invoice trade relationship with the customer, the vendor does not have a commitment to the customer to provide additional goods or services, other than what was provided under the purchase order honored by

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SO YOU WANT TO SUBMIT YOUR PREFERENCE ACTION TO BINDING ARBITRATION? THINK AGAIN

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It seems like a simple enough proposition – your company has just been sued for the return of certain transfers made by a debtor within the 90 days of filing its bankruptcy petition and you would like to submit the action to binding arbitration in accordance with your contract with the debtor. Unfortunately, according to the recent decision in *In re Bethlehem Steel*, bankruptcy courts have the right to deny such a request.

In *In re Bethlehem Steel*, four international creditors were sued for the return of alleged preferential transfers and sought to invoke their rights to binding arbitration under their contracts with the debtor. Their motivation was obvious – move the actions to a forum in which the trier of fact has a better understanding of their particular industry, a forum that is more cost-effective in which to litigate and one in which the trier is more understanding of their probable prepetition losses and reluctance to return funds to the non-operating debtor's estate.

The creditors moved to compel arbitration and the liquidating trust opposed the motions. The bankruptcy

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RECLAIMING TRADE VENDORS AND THEIR RIGHTS AGAINST POST-PETITION SECURED LENDERS

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A topic of growing importance to trade vendors is that of reclamation in the bankruptcy setting. With the record number of bankruptcy filings in the last year, and the predictions by most of the pundits on news outlets that the trend will continue at least in the short term, trade vendors have to look towards the Bankruptcy Code to determine their collection rights against their customers more often than in the past. A trade vendor's ability to reclaim its goods under state laws provide the trade vendor with the opportunity to physically take back its goods should the customer have the inability to pay for those goods if certain criteria are met. This has proven to be a useful tool for trade vendors wishing to minimize losses. However, in recent times, those same customers are increasingly filing for bankruptcy protection, and trade vendors must at that point look towards, among other things, their reclamation rights in the realm of bankruptcy.

Most trade vendors have become familiar with Bankruptcy Code section 503 (b)(9). This Bankruptcy Code section first appeared in 2005 with the implementation of the Bankruptcy Reform Act. Essentially, any goods sold and received by a debtor in the ordinary course of the debtor's business within the twenty days preceding the date of the filing of the petition entitle the trade vendor that sold and delivered those goods to an administrative expense priority claim, which claims receive priority in payment over other general unsecured non-priority claims. This is a powerful tool given to trade vendors under the Bankruptcy Code. However, a question arises as to goods that are delivered to customers that file for bankruptcy prior to that twenty day period. Do those goods simply make up a general unsecured claim for trade vendors? This is where the lesser known and utilized Bankruptcy Code section 546 is triggered.

Bankruptcy Code section 546 is a holdover from the days prior to the Bankruptcy Reform Act. It is essentially the Bankruptcy Code's reclamation statute. Under section 546, a trade vendor may reclaim goods delivered to a customer who has filed bankruptcy for all goods sold to that customer within the 45 days prior to the filing of the bankruptcy petition, if those goods were sold in the ordinary course of the customer's business, and written demand for their return is made within 45 days of receipt of the goods by the customer, or not later than twenty days after the filing of the bankruptcy petition. If the trade vendor is denied their right to reclaim the goods, the creditor is entitled to an administrative expense priority claim for the value of those goods.

Courts have interpreted section 546 to include some of the Uniform Commercial Code's reclamation requirement-

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FROM THE PUBLISHER:

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Guest Column

CREDITORS' RIGHTS SUMMERY POTPOURRI

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Linens Holding, Co., et. al. (Linens 'n things, Inc.) [08-10832 Bk. S.D., New York] update:

At the time L & T filed for Chapter 11 protection on 5/2/08, their top 50 creditors were owed slightly over $64M.

As of 5/12/09, 55 preference suits had been filed alleging preference payments totaling &105.4M and open credit memos totaling $30.6M for a total of $136M; $72M more than was owed to the top 50 creditors.

Creditors defending these preference suits will be tasked with proving that the preference payments were in the ordinary course of business between the parties, or were in the ordinary course of business within the relative industry. Additionally, they will have to prove that an open credit memo is not a preference and is in the ordinary course of business between the parties.

On the surface, proving ordinary course between the parties or within the relative industry should be fairly straightforward. The terms and conditions of vendor agreements issued by chain stores like L & T have long dictated how business transactions between the parties are carried out. Vendors to chain store customers have long understood that adhering to the terms of a vendor agreement is a 'necessary evil' if they want the business.

With regard to the issue of whether an open credit memo constitutes a preferential transfer, the answer may be found in the details of such transactions. In the simplest accounting terms, every entry has an offset; i.e., for every credit entry there must be a debit entry.

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UNITED AUTO WORKERS & THE NEW GENERAL MOTORS

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The United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) took a major risk when General Motors ("GM") filed for bankruptcy, the UAW bought a Chevy.

GM, the largest U.S. automaker, filed for protection under Chapter 11 of the bankruptcy code on June 1, 2009 in an attempt to restructure into a leaner and more efficient company. On July 10, 2009, after only 40 days, GM emerged from bankruptcy protection. GM, pressured into bankruptcy by numerous creditors, including the Federal government, which provided the Detroit giant with bailout money prior to the bankruptcy filing. The new GM is 61% owned by the American government.

Another entity which now owns a major stake in the new GM, along with the Federal government, is the UAW. The UAW is one of the largest labor unions in North America, with 513,000 active members and over 575,000 retired members.

It had been apparent for months that GM was in great financial trouble, in part due to the high costs of UAW labor from years of concessions made to the labor union. In March 2009, UAW workers made, on average, approximately $10 more per hour than non-union workers in the private, goods-producing, and service-producing industries. In part, the road to GM's bankruptcy was paved with flawed contracts and GM could no longer withstand the rising amounts of debt owed to the UAW.

As the dust settles on the bankruptcies of GM and Detroit's other automaker attempting to restructure, Chrysler, there are estimates that the UAW is now an owner of roughly 55% of Chrysler and about 17.5% of GM.

So is the UAW the big winner? Not really. It is most likely that the bankruptcies will weaken the union, not strengthen it. The agreements reached with the automakers have placed the union in a precarious position of needing to look out for the best interest of not only its members, but also the employer. The union and its laborers agreed to ratify a settlement agreement with GM, stating the UAW was willing to make, "painful sacrifices to preserve U.S. manufacturing jobs," as was noted in a UAW press release. But really, what choice did the UAW have, allow the hand that feeds them to fail?

Although the agreements reached between the union and GM allows for the UAW to become a major stakeholder, the bankruptcy process has allowed GM to trim fat out of the company. This should have been done years ago, but GM couldn't in part because of union opposition. Already GM cut brands such as Pontiac, and is in the process of selling off the Saturn, Saab, and Hummer brands.

GM's new slogan boasts, "We're not going out of business, we're getting down to business." So why wouldn't a leaner, more profitable GM benefit the UAW? One word: jobs.

The UAW derives its power from numbers. The more members the UAW has, the more negotiating power it has. However, with GM and Chrysler dramatically reducing product output in an attempt to regain profitability, the need for thousands of UAW workers is eliminated. The Wall Street Journal has reported that GM plans to shrink its U.S. employment from 88,000 employees to 63,000.

Not only did the gamble by the UAW risk the jobs of its members, but it is also forcing the union to change the way it does business. The UAW must now be concerned with how to run an auto company in the worldwide mar-

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NO RELIEF FOR TRIANGULAR SETOFFS UNDER THE BANKRUPTCY CODE

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In today's global economy it is not uncommon for a vendor to have contracts with multiple affiliate subsidiaries all owned by the same parent. As a result, many vendors include netting provisions in their contractual agreements that provide that if either party fails to meet its payment or delivery obligations, then the other party can offset any deliveries or payments against the defaulting party or one of its affiliates. This practice is known as triangular setoff.

Setoff is an equitable state law remedy that allows entities owing money to each other to cancel out or apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A. A triangular setoff occurs when A offsets an obligation to B against the indebtedness of B's affiliate C, to A.

At a first glance, triangular setoffs appear to be a great way for a vendor to protect its interests, especially in today's recessed economy when a corporation's fiscal health may be unpredictable. However, a recent court decision has questioned enforcement of prepetition triangular setoff agreements under the Bankruptcy Code.

Section 553 of the Bankruptcy Code does not create setoff rights, but instead preserves state law setoff rights, subject to certain limitations. In order to bring about an offset the creditor must: 1) enjoy an independent right of setoff under applicable non-bankruptcy law; 2) the debts to be offset must be mutual; and 3) the debts to be offset must be pre-petition.

Debts are considered "mutual" only

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VENDORS AS LENDERS OF LAST RESORT:

How trade credit may be indispensable to a financially struggling customer and how the vendor may benefit

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The freeze in the credit markets which made headlines in September, 2008, is still limiting traditional financing sources for what had been financially sound customers, resulting in many of those customers now struggling to meet their operating requirements. Underscoring the turbulent financing markets, the Wall Street Journal reports that 10 of the 13 financial institutions that received the majority of the $200 billion in TARP funds saw their loan balances decline. A recent update from Federal and Treasury officials note that banks continue to restrict business financing and do not foresee loosening for some time. In an effort to strengthen the loan market, the Federal Reserve extended the Federals Reserve's Term Asset Back Securities Loan Facility (TALF) to March 31, 2010. However, the federal government's funding efforts has not resulted in banks opening the credit gates. In this setting, vendors are finding customers unilaterally extending credit terms after invoices are due, not withstanding greater credit risk for the vendor, given the customer's default. The extended trade terms extracted from the vendor serve the customer's central purpose: the vendor is forced to serve as the lender of last resort, using extended credit terms, the customer is attempting to fill financing gaps abandoned by big banks.

Those customers that are unable to obtain sufficient financing may be forced to file chapter 11 in hopes of attracting debtor in possession financing. This means that vendors, especially those providing key goods and services, are having customers pressure them for terms in chapter 11. As a result, vendors are forced to re-evaluate their credit and collection policy, whether selling to a customer outside of a formal debt restructuring or to a debtor in possession. The credit professional finds himself in uncertain territory. On the one hand, the credit professional identifies greater credit risk with a customer pushing out credit terms and increasing the DSO, their employer's finance team complaining about extended terms and its impact on their own loan covenants. On the other hand, with the recession and sales declines, the sales force is pushing even more so to make a sale even where the

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(Continued from page 1)*SO YOU WANT TO SUBMIT YOUR PREFERENCE ACTION TO BINDING ARBITRATION? THINK AGAIN*

court denied the motions on the grounds that the preference claims were in the nature of statutory claims that could be pursued only by a trustee, debtor-in-possession or other estate representative, and that the preference claims were not claims of the debtor. The court also found that, even assuming the claims were arbitrable, the court could and would exercise its discretion to deny arbitration.

The *Bethlehem* court addressed the steps taken when analyzing an arbitration provision. First, the court must determine whether the parties agreed to arbitrate, which it found; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to stay the balance of the proceedings pending arbitration.

In support of its position that preference claims are outside of the scope of the arbitration provisions, the *Bethlehem* court simply found that while the debtor was a party to these broad arbitration provisions that covered all types of disputes between the parties, the trust, creditors, or their representatives were not. The creditors' response was that there are many instances where estate representatives stand in the shoes of the debtor and are bound by such prepetition contracts. But the court found that such matters are always derivative of the debtor's rights, and acknowledged that such derivative claims may be subject to arbitration. However, with respect to fraudulent transfer and preference claims, they are statutory claims created in favor of creditors that can only be prosecuted by a trustee or debtor-in-possession (or authorized representative).

In other words, claims asserted by the trustee under section 544(b) are not derivative of the bankrupt. They are creditor claims that the Bankruptcy Code authorizes the trustee to assert on their behalf. The Supreme Court has made it clear that it is the *parties* to an arbitration agreement who are bound by it and whose intentions must be carried out. Thus there is no justification for binding creditors to an arbitration clause with respect to claims that are not derivative from one who was a party to it.

Addressing its discretionary power to deny arbitration, the court recognized that preference claims are "core" proceedings, but that even core proceedings are not automatically subject to the court's discretionary power to stay arbitration. The court went on to acknowledge that federal policy favoring recognition of arbitration agreements is particularly strong for international agreements. However, the court found that there is a "severe conflict" between policies underlying arbitration agreements and the conduct of this bankruptcy proceeding such that "Congress intended to override the Arbitration Act's general policy favoring enforcement of arbitration agreements." In the end, even a foreign creditor's rights to arbitrate will not be recognized in the face of a pending preference action.

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the vendor. By contrast, under a supply contract, the vendor is committing its product or service for a period of time or duration of a project, for example. Under a supply contact, the customer may be attempting to lock in uninterrupted supply of the vendor's product or service, and perhaps a range of pricing. The customer may also need a longer term commitment from the vendor to plan sufficiently with its own customers.

The credit professional must consider the terms and conditions contained in the supply contract to give the vendor special protections to hold orders or terminate the contract should be the credit professional believe that the customer may be insolvent or otherwise cannot perform. This type of provision may be especially important in today's economy.

Chapter 11 Trend: Selling Assets vs. Earnout Plan

Customers struggling financially are getting cues from General Motors and Chrysler that they may resolve their financial difficulties through a chapter 11 filing, followed by a prompt sale of their assets pursuant to section 363 of the Bankruptcy Code. Assets sales are being used in a more creative ways from the view of the customer party buying the assets. For example, institutional shareholders, such as hedge funds, of customers are capitalizing a new company for the purchase of the customer's assets in chapter 11, rather than the customer selling its assets to a competitor or an unrelated third party financial investor.

This development of potentially more buyers of assets in chapter 11 may lead to more customers that are struggling financially to opt for a sale of assets, especially given a more flexible approach being adopted by bankruptcy courts in authorizing early sales.

Special Treatment for Supply Contracts Under the Bankruptcy Code

When a customer files chapter 11, the treatment of a vendor's claim is often dependent on whether the trade relationship in one where the vendor sold on an invoice by invoice basis or by a supply contract. With the invoice by invoice trade relationship, the vendor is not obligated to continue to sell the debtor postpetition.

By contrast, with a supply contract that is deemed executory, the vendor may be required to sell to the buyer based on the terms set forth in the contract. Not until the supply contract has been assumed or rejected may the vendor be able to evade selling post-petition.

Besides the difference of a vendor's obligation to sell the debtor postpetition based on invoice by invoice trade relationship or a supply contract, is the significant distinction of whether the vendor's prepetition invoices will be paid. This is highlighted in the Chrysler and General Motors bankruptcy cases, where the buyer of these companies' assets (Fiat and the "new" GM) elected to assume scores of executory contracts. Vendors with supply contracts ended up receiving a full assumption of their claims as they were assumed by third parties.

Bankruptcy Code section 365 gives special payment protections to a vendor whose supply contract is deemed executory: payment in full on the prepetition balance where the debtor assumes the supply contract and possibly assigns the contract to a buyer. In addition, a majority of courts recognize that where the supply contract is assumed, the vendor has a preference defense to payments received during the preference period.

Further, for the vendor there is less risk with credit sales after the supply contract has been assumed and assigned to a third party as the third party must provide financial assurance that it can perform under the contract. Generally, a buyer's assets balance sheet is much less leveraged and their ability to honor payment on the credit purchases should be much greater. Therefore, the sales force and management's objectives of maintaining market share in a recession can be better achieved with a supply contract as it provides the opportunity for sales and the vendor's prepetition debt is paid through the cure.

By contrast, the vendor that has sold invoice by invoice is not entitled to payment in full on the prepetition debt unless the bankruptcy court authorizes a critical vendor payment. From a debtor's view, the legal standard for having one vendor's contract assumed is much easier for creditors to support, and the bankruptcy court to approve, then to have a critical vendor motion approved. Thus, for the vendor having sold on an invoice basis, it is more difficult to have its prepetition claim paid.

Working With Sales Yet Managing Credit Risk

In a recession, the credit professional must work more closely with sales to make the sale, yet manage credit risk. This may mean selling to customers that have a higher likelihood of filing chapter 11, especially given the Chrysler and General Motor early sale examples. In this economic climate, the credit professional may need to re-evaluate the trade relationship and consider documenting the sale via a supply contract, with an eye towards managing credit and bankruptcy preference risk.

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ketplace, shifting away from its original primary motive of continually driving up the salary for its employees. The UAW can no longer be focused on providing its members short term benefits, but must focus on the long term health of GM in an attempt to strive for a symbiotic relationship between labor and capital.

The powerful labor union took a gigantic risk in making concessions and working with GM and Chrysler, however it is a gamble that the UAW had to take. UAW leaders know that their fate is tied to the American car industry.

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when they are due to and from the same persons in the same capacity. Pursuant to this definition can a triangular setoff ever be a mutual debt under the Bankruptcy Code?

Recently the United States Bankruptcy Court for the District of Delaware addressed this issue in the case *In re: Semcrude*, 399 B.R. 388 (Bank. D. Del. 2009). In *Semcrude* Chevron had entered into multiple prepetition contracts with SemCrude and its affiliate subsidiaries. Each of Chevron's contractual agreements contained a triangle setoff provision. Upon *Semcrude* and its affiliates filing for Chapter 11 Bankruptcy, Chevron moved for relief from the automatic bankruptcy stay to effect a triangular setoff.

The *Semcrude* court held that the Bankruptcy Code prohibits triangular setoff because it fails to satisfy the mandatory requirement of mutuality. Furthermore, contrary to Chevron's argument, the court held that there is no contractual exception to the mutuality requirement. In other words, a party can not contract to create mutuality where it does not exist.

Furthermore, the court reasoned that its holding was consistent with the broader policies of the Bankruptcy Code. The court instructed that one of the primary goals, if not the primary goal, of the Bankruptcy Code is to ensure that similarly situated creditors are treated fairly and enjoy an equality of distribution from a debtor. By allowing parties to contract around the mutuality requirement of Section 553, one creditor could unfairly obtain payment from a debtor at the expense of the debtor's other creditors, thereby upsetting the priority scheme of the Bankruptcy code and reducing the amount available for distribution.

What does the *Semcrude* decision mean for vendors doing business with affiliate and parent companies, especially in today's unstable economic conditions? Furthermore, what does the Semcrude holding mean for financially distressed affiliates? Will the *Semcrude* holding work to dissuade vendors from entering into agreements with these affiliates, thereby hindering their ability to effectively avoid having to file for bankruptcy?

If widely followed, the *Semcrude* case could result in unenforceable contractual agreements and therefore vendors may need to take steps now to restructure their agreements with affiliates and parents to ensure that they are protected.

(Continued from page 2) RECLAIMING TRADE VENDORS RIGHTS

First, the goods must still be in the now bankrupt customer's possession when the written demand is made. If the goods have been sold prior to the written demand, the reclamation rights of the trade vendor are extinguished. The reclamation rights of the trade vendor are also lost if the goods have been incorporated into the customer's inventories, such that identification of specific goods is not feasible. The typical case here is where the trade vendor provides a part of a finished product, and that part has been incorporated into the finished product so that it cannot now be segregated. For instance, envision a vendor that provides raw wood to Rolls Royce, which raw wood has already been milled, lacquered and installed as a dashboard prior to written demand for reclamation by the trade vendor. The trade vendor's reclamation rights are probably extinguished because its raw wood has been incorporated into the car, and the trade vendor is now unable to be segregate its raw wood from the rest of the car, or even the lacquer used to finish the wood for that matter. Lastly, and sometimes most importantly, the reclaiming trade vendor's rights to reclaim their goods are subject to the rights of a buyer in the ordinary course or a good faith purchaser.

This last requirement is important in the bankruptcy side of the world, because often there is a pre-petition secured lender involved. That lender's liens often extend to the inventory of the trade vendor's now bankrupt customer. It has been well established by bankruptcy courts that a reclaiming trade vendor's rights to reclaim are subject to the existing rights of a secured creditor in that a secured creditor has been held to qualify as a good faith purchaser under the reclamation statutes. Therefore, even if the trade vendor meets its requirements under section 546, they must always look to whether or not a pre-petition secured creditor exists that has a lien on the now bankrupt customer's inventory. If so, the trade vendor's rights to reclaim under section 546 are probably extinguished.

An interesting case on the topic of pre-petition secured creditors, and their ability to extinguish the reclamation rights of trade vendors under section 546 is the *Phar-Mor, Inc.* case. (301 B. R. 482 (2003)). Although there has been criticism of the case in legal publications and the like, it is still persuasive law in some jurisdictions. In *Phar-Mor*, a pre-petition secured lender had its pre-petition claim paid in full through proceeds from a post-petition secured lender. The trade vendors argued that their reclamation rights under section 546 could not be extinguished when the pre-petition secured lender is paid in full with proceeds from a post-petition secured lender. The court agreed. The court held that the pre-petition secured creditor's lien rights over reclamation creditors are not preserved to post-petition secured lenders. The court went on to state that "[a] debtor's decision to grant a security interest in inventory to a subsequent secured lender cannot defeat a seller's reclamation rights if the seller asserted its rights before the security interest is granted." The court essentially allowed the reclaiming trade vendors in the case, who made all the proper demands for the goods, and qualified otherwise under section 546 with the exception that the goods were no longer available to be reclaimed under the post-petition financing agreement, an administrative

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expense claim for the value of the goods sold and delivered within the requisite time periods.

With the ever evolving reclamation rights of trade vendors under statutory and case law, it is hard to gauge the impact and longevity of the *Phar-Mor* holding. However it proves to be a learning ground for trade vendors for two reasons. First, it shows that trade vendors should not simply give up on accounts receivables for customers that have filed for bankruptcy. Depending on the situation there may be a chance for a greater recovery than one would expect. Secondly, it is proof of the necessity that trade vendors become familiar with the Bankruptcy Code's reclamation statutes. These can be very powerful statutes for trade vendors, and having a fundamental understanding of them can prevent trade vendors from allowing valuable rights to pass them by.

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customer has defaulted on invoices. It may be management's objective to try and maintain market share by relaxing credit terms.

In this setting, what checklist can the credit professional consider to reduce credit risk, yet make the sale?

The Vendors' Due Diligence

The starting point for the vendor to evaluate whether to act, in effect, as the lender is determined by the character of the customer (revisiting the 5 C's) and their ability to repay the past due invoices as well as pay for new product or services. Like a bank lender, the vendor should insist on recent financial information from the customer, including a budget that forecasts the customer's ability to pay the past due balance. Should the customer push back, claiming their practice is not to share their non-public financial information with vendors, the vendor can offer a non-disclosure agreement as an accommodation to obtain the financial information. The financials should serve as the foundation for determining the term of the repayment agreement, if any. Other sources of information to assist in evaluating the customer's ability to pay over time include: the salesperson visiting the account, contacting the customer's bank as well as discussing the customer's financial standing with industry group members.

Past Due Invoices Substituted for Repayment Agreement

Where the customer refuses to honor the invoice terms, the vendor may agree to take payment over time, after the vendor has done its due diligence into the customer's ability to pay. To that end, the vendor should have the agreement for the customer to make payment over time on the past due invoices reduced to writing. A repayment agreement allows the vendor to fix the indebtedness with payment over time. Some of the terms to included in the repayment agreement are: a waiver of counter claims and disputes, the most-favored creditor treatment clause, a stipulated judgment or confession of judgment; a payment schedule should accompany the repayment agreement, whether the schedule is on a weekly or a monthly basis. This provides you with a clear timetable for repayment of the delinquent account, which assists for financial reporting purposes, especially if SOX compliant.

In order to have the customer abide by the repayment agreement, the vendor may agree to discount the face amount of the past due invoices to reach a compromise. The agreement may provide that in the event of a default by the customer, the face amount of the past due invoices becomes due and payable, causing the debtor to lose the discount. Should the customer default on the repayment agreement, the customer allows the vendor to promptly proceed to judgment.

The customer likely will view the repayment agreement as an opportunity for additional product or service on credit terms. Again, the vendor's due diligence of recent financial information assists in determining credit risk for new sales. In a recession, the opportunity for sales, even where a customer has defaulted on invoices, may still be considered should the customer's financial information indicate a turning point.

Post-Petition Credit Sales

Notwithstanding the vendors' efforts to keep the customer out of bankruptcy by agreeing to take payment over time, the customer may still be forced to file Chapter 11. In Chapter 11, a vendor is also finding the customer's need for trade credit as great as the need pre-bankruptcy. As with customers difficulties in getting financing outside of bankruptcy, customers filing chapter 11 find obtaining debtor in possession financing difficult. Many financial institutions that had been key sources of DIP financing have exited this market.

Therefore, a chapter 11 debtor is pressing its key vendors for postpetition credit terms in a number of settings. For example, if the vendor shipped goods that the debtor received within 20 days of the chapter 11 filing, they are entitled to administrative priority. However, the Bankruptcy Code does not state that the administrative claim must be paid immediately. Therefore, many debtors are pressing vendors that hold the 20 day claims to extend postpetition credit in exchange immediate or early payment of the 20 day claims. Likewise, chapter 11 debtors may seek critical vendor treatment for their vendor class for the purpose of obtaining postpetition trade credit. Chapter 11 debtors are also considering trade vendor liens for the purpose of obtaining trade credit from a class of vendors in exchange for the vendors obtaining a junior security interest in the debtor's assets. In each example, the debtor needs trade credit to operate its business in chapter 11. The upside for the vendor is the profit from continued sales and perhaps immediate payment on the prepetition balance that is owing.

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(Continued from page 2)*CREDITORS' RIGHTS*

Vendors do not issue credit memos without reason, or 'backup.' Credit memos are generally issued by a vendor to offset deductions or charge-backs taken by a chain store customer. The vendor's credit memo should automatically offset or match a debit created by the chain store customer's deduction or charge-back. Each party is responsible for seeing that their own accounting system properly records and/or offsets these types of transactions. A vendor's efforts to keep its accounts receivable up to date and "clean" of open credit memos are completely separate from any such effort, taken (or not taken) by a retail chain customer to keep their accounts payable accounts 'clean.' A vendor should not be held accountable or penalized if a retail chain customer does not do the diligence necessary to offset the vendor's credit memos against their debits or charge-backs.

In the L&T preference suits, many of the open credit memos alleged to be preferential occurred well before the 90 day preference period. How then, can these "old" open credit memos be considered preferential?

No doubt there will be more issues raised in the prosecution and/or defense of the L&T preference cases. However, the two raised above seem obvious and it will interesting to see how the Court rules on these issues.

Automotive supplier preference suits update:
As we stated in our Special Automotive Industry Issue released 12/29/08, the downward spiral of the automotive suppliers began in early 2005 when Tower Automotive, Inc. filed for Chapter 11 protection. Since then, eight more Tier 1 suppliers have filed: Meridian Automotive Systems, Inc.; Collins & Aikman Corp.; Delphi Corp.; Dana Corp.; Dura Automotive Systems, Inc.; Metaldyne Corp.; Visteon Corp.; Lear Corp., and J. L. French Co. Total amount due to creditors by these suppliers at the time bankruptcy petitions were filed exceed $8B.

To date, several hundred preference suits have been filed in the above listed bankruptcies. The majority of these suits were filed against "John Doe" creditors, with any settlement agreements sealed. However, it appears that many are yet to be resolved. It remains to be seen if the exit from bankruptcy by GM and Chrysler will have any affect on these suits.

Despite the fact that GM and Chrysler have exited bankruptcy reorganization, bankruptcy filings within the automotive industry are expected to continue. It is estimated that there are 30,000 individual parts in a modern domestic automobile for which there is no single source. Suppliers provide components and systems that constitute an estimated 70% of the value of the average vehicle. Each auto manufacturer has an estimated 900—1,000 Tier 1 suppliers. Industry sources indicate that up to half of these suppliers could file for bankruptcy protection during the remainder of 2009 and well into 2010. Predictions of failure among Tier 2 and 3 suppliers have not been seen at the time of this writing. However, restructuring by auto manufacturers will continue to apply downward pressure on the supplier base to take on more functions such as design and sub-assembly . As a result many suppliers providing services and/ or products to the upper tier suppliers are not expected to survive such pressure.

Creditor's Rights Odds 'n Ends:
Data warehousing [offsite storage] has long been used by medium to large-sized companies for collection, storage and staging of corporate data. Offsite storage of historical corporate data allows ERP system users to utilize their memory capacity for daily or current data processing. While the concept of data warehousing makes good business sense for storage of historical data, creditors and attorneys frequently forget about the data in litigation proceedings. Rule 34 of the Federal Rules of Civil Procedure [FRCP], amended 12/08, describes electronically stored information as "*any designated documents or electronically stored information—including writings, drawings, graphs, charts, photographs, sound recordings, images, and other data or data compilations—stored in any medium from which information can be obtained either directly or, if necessary, after translation by the responding party into a reasonably usable form;*"[1] Since most creditors' rights or preference litigation actions occur months or even years 'after the fact,' creditors often forget about transactional data stored offsite.

Written Corporate credit/collection policies and procedures are important in providing ongoing guidance for the performance of daily credit and collection functions. They also form the basis for the manner in which a creditor may conduct its business relationships with customers. Such policies and procedures should be frequently reviewed and updated to keep pace with any changes within the creditor's industry or its business operations. Observance or non-observance of a creditor's policies and procedures has been raised as an issue in numerous preference suits. Plaintiff's counsel often claim that non-adherence to its policies and procedures by a creditor is not in the ordinary course of business. Also, plaintiff's counsel have claimed that creditors have not equally or fairly applied their policy and procedures to all of its cus-

(Continued on page 9)

(Continued from page 8)*CREDITORS' RIGHTS*

tomers and therefore, is not in the ordinary course.

EDI, EFT, etc. Electronic Data Interchange and Electronic Funds Transfer have long been used by large corporations for dealing with their vendors. As an example, Wal-Mart and The Kroger Co. both require that *all business transactions* with vendors be conducted via EDI. The Kroger Co.'s EDI Programs & Requirements web site states "*The EFT program will consolidate payments for all Kroger divisions into one payment made to a particular vendor on a given day. Electronically transferring the funds and remittance detail benefits both the Kroger Co. and its vendors. Integrating the payment information with a company's existing cash management system and payment application processing, will maximize these potential benefits.*"[2] Advances in software and technology have allowed more and more companies to conduct business with vendors and customers electronically.

ANSI (American National Standards Institute) through various subcommittees developed codes for use in electronic data transfer and refer to the 'transaction set' for a single business documents; I.e., 850—Purchase Order, 810-Invoice, 856-Shipping Notice, 812-Credit/Debit Adjustment, and 820-Payment Order/Remittance Advice. ANSI standards govern the translation of 'human readable' data to 'machine readable' formats to electronically transfer business transactions between parties.

Although EDI and EFT have been in use for more than 30 years, users were generally limited to large companies. However, advances in software and hardware development have made their usage more commonplace. The use of EDI and EFT by creditors can play a role in and ordinary course of business defense in a preference action when determining payment history and industry standards.

(Continued from page 7) *VENDORS AS LENDERS*

The Vendor as Lender Mindset

Customers need trade credit to meet the short term obligations more than ever. During this recession, vendors are having a more difficult time meeting their revenue goals as customers simply do not have the need for as much of the vendor's product or service. In this setting, the vendor does have the opportunity to meet the sales force and management's objectives to try and maintain market share in a down economy by continuing to sell a customer on modified terms even where the customer seeks to stretch out open invoices. Following a lender's play book, key for the vendor's evaluation act like a lender is the customer's sharing recent financial information, including projections which support repayment of the vendor's delinquent account.

Post-petition credit sales carry opportunities while creating a risk of liquidation. DIP financing does not guarantee payment of post-petition credit sales, but it may allow a creditor to receive payment before general unsecured creditors. Trade lien programs encourage vendors to sell on credit but are junior to a DIP lender. The critical vendor doctrine is another option once the debtor has moved into bankruptcy and trade creditors and discrimination are considerable with the plan of reorganization.

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Blakeley & Blakeley LLP Upcoming Engagements and Activities for 2009

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

Scott Blakeley's Speaking Schedule:

- ◊ August, 2009:
    - ◊ Newport Beach, CA: Credit Services Group
        - ◊ Getting Paid on Your Delinquent Accounts
    - ◊ National Broadcast:
        - ◊ Webcast: The Red Flags Rules
        - ◊ *To join the webcast, email slincoln@blakeleyllp.com*

- ◊ September, 2009
    - ◊ Chicago, IL: NACM, Corrugated Manufacturers Group
    - ◊ Indianapolis, IN: Roche Diagnostics Corporation
    - ◊ Kansas City, MO: NACM Conference
    - ◊ San Diego, CA: Swimming Pool and Spa National Industry Group

- ◊ October, 2009
    - ◊ Las Vegas, NV: WRCC Delinquent Accounts
    - ◊ San Diego, CA: Vision for the Council Committee
    - ◊ Oregon: NACM
    - ◊ Tampa, FL: NACM Conference: Delinquent Account and Creditors' Right Panel
    - ◊ Nashville, TN: Ingram Industries, Waterway Carriers Group

- ◊ December, 2009
    - ◊ Newport Beach, CA: NACM

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