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THE TRADE VENDOR QUARTERLY

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

THE PROBLEM WITH AN INACTIVE CREDITORS' COMMITTEE

Scott Blakeley

Your problem account which you extended an unsecured credit line of six figures has filed chapter 11 bankruptcy (the reorganization chapter of the Bankruptcy Code). You are scheduled by the debtor as holding one of the 20 largest unsecured claims. You receive a Creditors' Committee Solicitation Form from the Office of the United States Trustee (OUST) inviting your company to serve on the official committee of unsecured creditors. Should you submit the Solicitation Form to serve on the creditors' committee?

In balancing your decision whether to serve, membership on the creditors' committee often involves months of difficult work by committee members who receive no compensation for their time other than reimbursement of their expenses. With an active creditors' committee, membership may confer several key benefits including: access to financial and other information of the debtor; greater contact with the debtor; input and the right to vote on the position the creditors' committee takes; input on the debtor's business reorientation; and input in the formulation of the plan of reorganization. In other words, membership on an active creditors' committee provides you with greater control over the amount and method of payment of your pre-petition claim and greater control over the direction of the debtor's business.

When the drafters of the Bankruptcy Code removed the bankruptcy judge as overseer of a chapter 11 case, they envisioned an active creditors' committee playing a central role in the reorganization process. Thus, when there is no active committee, no trustee appointed and no direct court supervision, the debtor may operate virtually unchecked.

Appointment Of Creditors' Committee

Upon the filing of a bankruptcy petition, payments to unsecured creditors are suspended and vendors are entitled to assert claims for the unpaid value of their goods and services against the debtor. The typical chapter 11 bankruptcy often has hundreds, even thousands, of unsecured vendors, many of whom hold claims of relatively modest amounts. A creditors' committee is intended to deal with the debtor in a more manageable fashion than the entire body of unsecured creditors could, permitting them to speak in one voice and assuring representation of creditors who would otherwise

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RECLAMATION -- A PRIMER

Brad Blakeley

From the perspective of a vendor, the news of a customer's insolvency can be devastating. However, the right of reclamation may afford a creditor a material and cost-effective method of recovery.

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. It is based upon the premise that the seller was defrauded. Under the common law and the old Uniform Sales Act, the seller could only exercise its reclamation rights if it proved the buyer obtained delivery by misrepresenting its solvency. However, the Uniform Commercial Code (UCC) has expanded this remedy to situations where the buyer does not misrepresent solvency. Recognizing that the seller has given the buyer the appearance of authority to sell the goods by delivering such goods to the buyer, the UCC has made the seller's reclamation rights subject to a good faith purchaser from the buyer.

The bankruptcy court must have the ability to structure the proceedings in such a way that the debtor has a reasonable chance to make a fresh start. Therefore, the Bankruptcy Code provides the court with the ability to grant a seller a lien or priority claim instead of ordering return of the goods. The flexibility inherent in allowing alternatives to the reclamation claim, gives the

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NO SECURITY AGREEMENT CREATED BY DEBTOR'S SILENT PAYMENT OF INVOICES UNLESS DEBTOR AND VENDOR BARGAIN FOR SECURITY INTEREST

Scott Blakeley

Selling goods to a customer on a secured basis? Are you providing a service which entails taking possession of your customer's goods? It is a tempting precaution to assert a security interest in those goods. The recent decision of In re CFLC, Inc. fka Everex Systems, Inc.[1] reminds vendors that, when selling goods or services to a debtor, the vendor's security interest in those goods must be bargained for expressly. If the security interest is not negotiated by both parties, the vendor risks that its security interest can be avoided.

Security Agreement Created?

In In re CFLC, Inc., the vendor provided freight forwarding services to the debtor. The services included ocean shipping and customs brokerage. The vendor billed the debtor on its regular invoices, which were issued one at a time to correspond with each shipment. The vendor sent the debtor approximately 330 invoices, each preprinted with identical terms. The back sides of the invoice listed the "Terms and Conditions of Service" which contained a section regarding a general lien on property:

> "General Lien on Any Property. The Company shall have a general lien on any and all property (and documents relating thereto of the Customer, in its possession, custody and control or en route, for all claims for charges, expenses or advances incurred by the Company in connection with any shipments of the Customer and if such claim remains unsatisfied for thirty (30) days after demand for its payment is made, the Company may sell at public auction or private sale . . ."

FROM THE PUBLISHER:

The Trade Vendor Quarterly ***is published by the law firm of Blakeley & Blakeley LLP and is distributed as a service to clients and other parties interested in creditor issues. Blakeley & Blakeley LLP cannot be held responsible for the accuracy of information contained in articles written by guest contributors.***

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If you have a hot topic affecting the credit and financial professional, e-mail this to Scott.

The debtor never signed the invoices nor entered into any agreement with the vendor regarding a general lien. It was never discussed between them that the vendor could assert any lien over the services it provided.

The debtor filed Chapter 11 bankruptcy. Just prior to the bankruptcy filing, the vendor informed the debtor that, due to nonpayment of the invoices, the vendor would be asserting its lien over the goods that were currently in its possession. The validity "lien" was disputed by the creditors' committee of the bankruptcy estate. The bankruptcy court ruled that the vendor did not have a valid lien on the goods in question, and was thus an unsecured creditor. The vendor appealed.

The vendor contended that a security interest had been established by virtue of the terms of its invoices, combined with the parties' course of dealing. In other words, because the debtor had failed to object of the terms printed on the invoices, and had continued to transact business with the vendor, it was operating subject to the vendor's terms and so there was a security agreement as provided for in Article 9 of the Uniform Commercial Code (UCC).

No Security Interest Under Article 9

A security interest is generally defined as an interest in personal property or fixtures which secures payment or performance of an obligation on behalf of the creditor. A formal, binding security agreement must exist to make the security interest enforceable. Such an agreement must describe the property in which the debtor has conveyed a security interest to the creditor. In this case the debtor did not sign a security agreement; however, the vendor argued that its invoices, combined with the parties' course of dealing, was evidence of a security agreement.

The court observed:

> "It has been held that the repetitive use of a standard form by one party, without a meeting of the minds or express agreement, is insufficient to establish a course of dealing . . . Where there was no communication concerning a security interest over the pertinent course of the relationship, the unilateral production of terms to [the vendor's] liking was insufficient to create a contract."

There was no evidence that the debtor agreed to the lien terms. The debtor neither expressly acknowledged nor objected to the lien terms on the reverse side of the invoice. The parties had never discussed the terms of the invoice nor negotiated for a security interest. The court observed that the debtor paid the invoices was evidence that the parties had a contract for shipment of goods. However, it was not evidence that the debtor consented to the terms granting the vendor a general lien.

The court further addressed the possibility of a carrier's lien, but defined carrier's lien as a specific lien attaching to goods involved in a single transaction. A carrier's lien was not applicable to this case.

The Bankruptcy Code's "Strong Arm" Powers

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A HISTORY OF BANKRUPTCY PREFERENCES

Scott Blakeley [1]

I. INTRODUCTION

A fundamental principle of bankruptcy law since its advent in the sixteenth century is equality of distribution. This principle disfavors transfers that benefit one creditor at the expense of other creditors. Preference laws are central to this principle and they are the primary instrument in achieving equality of distribution.

The preference laws have evolved as an offshoot of fraudulent conveyance law, thus containing broad ethical pronouncements of sixteenth century English bankruptcy law and to standardized, technical rules of twentieth century American bankruptcy law. The focus of preference laws has shifted from the culpability of the debtor, to the culpability of creditors, to the present day standard of strict liability.

Preference laws seek to deter individual creditor action by threatening recapture of transfers made during the debtor's period of vulnerability. Closely associated with the tenet of equality of distribution is the bankruptcy policy of maximization of the bankruptcy estate. A larger distribution might be achieved through rehabilitation rather than liquidation. Preferential transfers result in diminishment of estate assets, thus frustrating decisions that would achieve maximization.

II. ENGLISH BANKRUPTCY LAW: CREATION OF THE PREFERENCE

Since 1570, English law has prohibited transfers by a debtor for the purpose of defrauding creditors. The penalty imposed for the crime is forfeiture of the property transferred and imprisonment of the debtor. The emergence of preference law was closely tied to the law of fraud. Although the concept of pro rata distribution appeared in the first comprehensive bankruptcy statute, The Statute of 13 Elizabeth, the Statute was silent as to preferences. Early preference law developed through case authority.

In 1584, equality of distribution was introduced as a fundamental principle of bankruptcy law in the The Case of Bankrupts. In his pronouncement, Lord Coke stated that "[T]here ought to be an equal distribution. . .; [for] if, after the debtor becomes bankrupt, he may prefer [a creditor] and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a defect in the law."[2] This principle of equality advanced by Lord Coke viewed preferential transfers as defeating the principle of fairness.

Later cases further developed the doctrine of equality of treatment of creditors. Lord Mansfield held that the debtor must not set himself up as the law-giver in bankruptcy distribution. Therefore, transfers on the eve of bankruptcy were void where creditors had not demanded payment or threatened to bring suit. Payments to creditors, on the eve of bankruptcy, who had threatened to collect their debts were not considered preferential.

In 1746 Parliament created a bona fide creditor law, intending to protect innocent creditors from avoidance payments. Courts distinguished between good and bad transfers. In a good transfer:

> (1) the claim had to arise in a bona fide credit transaction and in the ordinary course of trade; (2) the payment had to be made in the ordinary course of trade; and (3) the creditor had to not know or have notice that the debtor at the time was bankrupt or insolvent circumstances.[3]

A bad transfer required debtor intent to benefit a creditor to the detriment of other creditors. The ethical inquiry under English preference law focused principally on the state of mind of the debtor, not on the actions of the creditor. Under this analysis the aggressive creditor was rewarded:

> [I]f a bankrupt, in a course of payment pays a creditor, this is a fair advantage in the course of trade; or, if a creditor threatens legal diligence, and there is no collusion; and he make an assignment of part of his goods; it is fair transaction, and what a man might do without having any bankruptcy in view . . . if done in the course of trade, and not fraudulent may be supported.[4]

The statute advanced a central theme in preference legislation: Preferential payments are contrasted with some sense of ordinary commercial practice. The goal of preference laws was to capture fraud and not unwind a transaction in the ordinary course. The focus of English bankruptcy law was not ensuring a mathematical pro rata distribution of assets, but rather, to prevent a debtor from creating his own form of distribution to creditors.

In 1869 Parliament drafted a preference provision into its bankruptcy legislation. The preference law provided that any payment made within three months of bankruptcy, for the purpose of giving the creditor a preference, was void.

III. AMERICAN BANKRUPTCY PREFERENCE LAW

Switching continents, a central consideration in American preference legislation is the review of changing relationships (1) between debtor and its creditors, and (2) among debtor's creditors.

A. Early American Bankruptcy Law

1. The State's View

State regulation of preferential transfers began in the late eighteenth century. Under these laws, the debtor's state of mind was essential in determining a preference.

2. The Bankruptcy Act of 1800

The first American Bankruptcy was the Bankruptcy Act of 1800 While fraudulent conveyances were included in the Act of 1800, preference actions were not.

3. The Bankruptcy Act of 1841

The Bankruptcy Act of 1841 was the first to define and prohibit preferences. Any transfer by the debtor, within a two

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ESSENTIALS OF LETTERS OF CREDIT

Scott Blakeley

Letters of credit (L/C) have long served as a convenient, inexpensive means of payment in domestic and international trade. L/C's may serve as guaranties, securing performance obligations with a bank's commitment to pay upon presentation of a draft, default notice or other documents specified by the L/C. L/C's have long been governed by Article 5 of the Uniform Commercial Code. The L/C is intended to assure the vendor of payment before the goods leave its warehouse.

What is a Letter of Credit?

An L/C may be broadly defined as an undertaking by an issuer, the bank, to pay a third party, the vendor who is the beneficiary for the account of the bank's customer, the debtor, when the vendor submits documents specified by the L/C. If the vendor submits proper documents before the credit expires, the bank will pay the L/C, and the debtor must reimburse the bank. An L/C may be either revocable or irrevocable. An irrevocable L/C can be modified only with consent of the vendor. A revocable L/C can be modified by the bank without the vendor's consent. L/C's come in two varieties: commercial L/C's, commonly used to pay for goods, and "standby" L/C's, which secure performance by assuring payment after default. Under either type, the credit of the bank is substituted for the credit of the debtor in favor of the vendor.

Essential Principles

Governing Law

Within the United States, Article 5 of the Uniform Commercial Code (UCC) governs L/C's. Article 5 is founded upon two principles: (1) the L/C's independence from the underlying business transaction, and (2) strict compliance with documentary requirements.

The Independence Doctrine

L/C's are purely documentary transactions, separate and independent from the underlying contract between the debtor and the vendor. The bank honoring the L/C is concerned only to see that the documents conform with the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the debtor. The bank need not look past the documents to examine the underlying sale of merchandise. The letter of credit is independent from the underlying transaction, and except in rare cases of fraud or forgery, the issuing bank must honor conforming documents. Thus, vendor's are given protections that the issuing bank must honor its demand for payment (which complies with the terms of the L/C), regardless of whether the goods conform with the underlying sale contract.

Strict Compliance

The bank may insist upon strict compliance with the requirements of the L/C. In the absence of conformity with the L/C, the vendor cannot force payment and the bank pays at its peril. The question remains, how strict compliance? Some courts insist upon literal compliance, so that a misspelled name or typographical error dooms the vendor's demand for payment. Other courts require payment upon substantial compliance with documentary requirements. Careful vendors should remember that the bank may insist upon strict compliance with all documentary requirements. If the documents do not conform, the bank should give the vendor prompt, detailed notice, specifying all deficiencies.

Forms of Letters of Credit

Commercial Letters of Credit

This form of L/C is commonly used when the contract involves sale of goods. Many exporters require payment by letter of credit. Typically, the buyer applies to his bank, which opens a letter of credit in favor of the exporter, payable upon presentation of the seller's draft, bill of lading and other shipping documents specified in the credit. When the goods are shipped, the seller delivers those documents to the bank and collects full payment. The bank holds the documents and usually takes a security interest, pending reimbursement by its customer, the buyer. The transaction involves three relationships: (1) the letter of credit, which obligates the bank to pay the beneficiary upon presentation of the documents; (2) the reimbursement agreement between the bank and its customer, which obligates the beneficiary to reimburse the bank and pay a fee; and (3) the underlying contract for sale of goods.

Standby Letters of Credit

A standby L/C is customarily used in nonsales transactions. This form of L/C assures payment in case of nonperformance. Under the commercial L/C, the vendor's right to payment is conditioned upon submitting certain documents; with standby L/C's a vendor draws down on the L/C only when the vendor establishes that the debtor has defaulted. For the commercial L/C, payment is expected; for the standby L/C, payment should be the exception.

The Parties' Rights And Obligations

Issuing Bank

When an issuer receives a draft and demand for payment, it must decide to honor or dishonor within three banking days under the UCC. The bank must examine the documents with reasonable care. If the documents conform, the bank must pay, and be reimbursed by its customer, the debtor. Failure to honor within three banking days constitutes dishonor. If the documents do not conform, the bank should give the beneficiary prompt, detailed notice, specifying all deficiencies.

Vendor

The vendor is entitled to payment upon submission of proper documents. By presenting its draft and demand for payment, the vendor represents that all conditions of the L/C have been complied with.

Debtor

The debtor must reimburse the bank when the bank honors conforming drafts and demands, i.e. the debtor unconditionally agrees to reimburse the bank.

A HISTORY OF BANKRUPTCY PREFERENCES (Continued)

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month reach back period, was illegal if made for the purpose of benefitting a particular creditor. As a result of an illegal preference, the debtor would lose his discharge. The Act of 1841 did not consider "state of mind" as an element in finding an illegal preference.

4. The Bankruptcy Act of 1867

The Act of 1867 made it easier to find a preference. In addition to extending the reach back period to four months, it changed the "debtor's contemplation of bankruptcy" condition to the "debtor's insolvency or contemplation of insolvency." Insolvency, however, was not defined. The Supreme Court defined insolvency as a debtor's inability to meet debts as they come due. The 1867 Act also added the "state of mind" condition requiring the creditor to have reasonable cause to believe the debtor was insolvent.

B. A Technical Approach to Preferences

1. The Bankruptcy Act of 1898

The Act of 1898 promulgated an elaborate scheme for regulating preferences. It is viewed as the key which ensured ratable distribution. Section 60a provided:

> [A debtor] shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer [would] be to enable any one of his creditors to obtain a greater percentage of his debt than any other such creditor of the same class.

The 1898 Act reflects a shift in preference philosophy from the debtor's moral duty to his creditors to the preferred creditor's moral duty to fellow creditors. The debtor's state of mind in making the preference become irrelevant. The focus was now on to state of mind of the creditor. A transfer was avoidable provided the preferred creditor has reasonable basis to believe that the payment would cause a preference. The preference laws were intended to punish bad creditors, i.e. those that know of the debtor's insolvency. The Act's shortfall was that itincluded an abstract definition of preference giving the courts too much flexibility in its application.

The Act of 1898 also addressed the secret lien, whereby a debtor who provide a creditor with a security interest well before the reach back period but who did not perfect the lien until the eve of filing, would fall within the relation back doctrine. Under this doctrine, liens were viewed as arising during the four month reach back period and could thus, be avoided.

A number of courts, however, refused to avoid the secret liens. These counts held that such creditors deserved to be paid. Congress amended the preference laws in 1910 and 1926 to strictly apply the relation back provision. Moreover, until recovery of the preferences, the creditor's claim would be disallowed.

2. The Chandler Act of 1938

The Chandler Act continues the trend to a more technical application of preference laws. The Chandler Act re-emphasizes that ratable distribution is the essence of bankruptcy laws and preference laws are the vehicle to achieve this. As with the Act of 1898, the focus of the legislation was avoidance of secret liens and last-minute liens, and its purpose was to prevent rewards to preferred creditors, insiders and creditors exerting economic pressure.

3. The Bankruptcy Reform Act of 1978

The Bankruptcy Reform Act fundamentally changed American preference law. The drafters of the Bankruptcy Reform Act created a preference law, section 547 of the Bankruptcy Code, which was a precise, technical rule of definitions and numbered exceptions intended to avoid transfers that upset a ratable distribution. Congress sought to simplify the preference laws and restrict court interpretation of these provisions through technical drafting and on rule-oriented approach. The rule shifts the onus of preference litigation from debtor to creditor.

The principle objective section 547 is:

> [T]wo-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge it so that all may share equally. The operation of the preference section to deter the "race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section-that of equality of distribution.[5]

The significant additions and revisions to the preference law under the Bankruptcy Reform Act include the following.

a. Reasonable cause to believe

The Bankruptcy Reform Act made it easier to establish the existence of a preference by eliminating the requirement that the creditor have reasonable cause to believe that the debtor was insolvent (except for insider creditors). The state of mind element is eliminated, in part, out of concern that the innocent creditor exception conflicts with the policy of equality among creditors.

b. Vulnerability period shortened

The reach back period is shortened from 120 days to 90 days.

c. Presumption of insolvency

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THE PROBLEM WITH AN INACTIVE CREDITORS' COMMITTEE (Continued)

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be unable to effectively participate in the bankruptcy because of economic constraints.

The formation of a creditors' committee aids the debtor and the bankruptcy court as it provides for a centralized body vendors to be heard and dealt with. The creditors' committee's chief responsibilities are to act as liaison and watchdog between the debtor and its constituency, the unsecured creditors of the estate, and to ensure a fair settlement of the debtor's financial difficulties in compliance with the Bankruptcy Code.
tangible and intangible assets as well as liabilities that the debtor has listed as property of the estate. The committee may also investigate assets and liabilities that were not scheduled.

The need for the creditors' committee to investigate the affairs of the debtor is based on the assumption that the debtor may be unwilling to investigate itself. Investigations often are conducted informally through meetings and exchange of documents. When there is no cooperation, investigation proceeds formally through examinations and document production pursuant to bankruptcy court order. The debtor's post-petition performance is reviewed by the committee via interim statements and operating reports that the debtor is obligated to file with the OUST.

Formulation of a Plan of Reorganization

In a chapter 11 proceeding, a plan of reorganization is the vehicle by which a debtor repays its creditors. The plan is the pivotal event in the chapter 11. The creditors' committee is the primary negotiating body for the formulation of a plan. The committee has standing to propose its own plan provided certain conditions are met.

Appointment of Trustee or Examiner

When there is no active committee, no trustee appointed, and no direct court supervision, a debtor may operate virtually unchecked. The creditors' committee has standing to request the appointment of a trustee or examiner. While there is a presumption that a debtor's management should remain in possession of the business in chapter 11, i.e., debtor's management continues to operate the business, a clear and convincing showing of fraud, dishonesty, incompetence, or gross mismanagement by current management may be "cause" for the appointment of a trustee, or where the appointment is in the interest of creditors. The creditors' committee has standing to request the appointment of a trustee or examiner.

As an alternative, an examiner may be appointed. Upon a showing that appointment of an examiner is in the best interests of the estate, or the debtor's non-trade debt exceeds $5 million, an examiner may be appointed. The examiner has a narrow role: he or she is an objective investigator employed by the bankruptcy court to perform specific tasks, such as investigating particular assets, liabilities or conduct of the debtor. The examiner does not replace management, has no operational responsibility and no express right to retain professionals. The examiner will file a report of his or her findings.

The Creditors' Committee Acts?

The need for an active creditors' committee was recently examined by the bankruptcy court in In re ABC Automotive Products Corp.[1] The court reviewed the propriety of committee members furnishing proxies to an attorney who essentially acted as the committee. The court was troubled by the failure of committee members to actively participate on the creditors' committee.

In ABC Automotive Products Corp, the debtor, an automotive aftermarket distributor, filed chapter 11. After some delay, the OUST appointed four members to the creditors' committee. The committee selected counsel.

At the same time, an attorney at another law firm was attempting to secure the committee counsel job for his firm. The debtor's president identified this attorney as the contact person to vendors who inquired, after learning of the bankruptcy petition, "What do I do next?" Consequently, the new attorney was called by nine of the twenty largest vendors, when he asked whether they wished him to be committee counsel. Following these conversations, the new attorney sent a proxy form to the vendors. Six proxies were returned to the new attorney. The attorney then contacted the OUST.

The OUST amended the appointment of the creditors' committee to include three new members. The new attorney held proxies for four of the seven members.

After receiving the amended appointment of the committee, the new attorney sent a letter to the members of the committee announcing of his intention to hold a meeting of the committee. He further added that this meeting was "for the sole purpose of appointing a chairman and appointing counsel to the Committee." Receiving no response from any of the members, the new attorney held the meeting and appointed his firm as committee counsel, using the proxies he held. The former attorney and the OUST objected to the new attorney's appointment as counsel to the committee.

The Problem With An Inactive Committee

While the Bankruptcy Code and reported cases set out the duties of creditors' committees, what happens when committees such as this one fails to act? Is there potential liability for someone who is a member of an inactive committee? The ABC Automotive Products court observed:

> "[F]ew decisions under the Code impose liability on committees or their members for failing to exercise the statutory powers that enable committees to participate actively in the reorganization process. Perhaps the same apathy and sense of hopelessness which often results in inactive committees also produces creditors who fail to consider whether the committee properly represented their interests . . .However, heightened awareness among creditors and their counsel about the committee's responsibilities to those it represents may result in the emergence of claims against inactive committees and committee members. Such claims might prompt the committee . . .to carry out more fully and effectively the role Congress intended them to play in the reorganization process."[2]

The court considered several reasons that vendors are reluctant to serve on a committee. These reasons include unfamiliarity with the role they would be expected to assume, the burden of fiduciary duties owed

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THE PROBLEM WITH AN INACTIVE CREDITORS' COMMITTEE (Continued)

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to unsecured creditors, and the burden with the responsibilities which membership on the committee entails.

Proxies Do Not Pass Muster Here

The court found that the procedures the new attorney utilized in electing committee counsel were plagued with problems. The speed with which the "meeting" was called and held left no real opportunity for participation by committee members. Members were told that their silence would be assent, and if they wished to object, they were subject to various procedural requirements. The court found the new attorney had no justification for the short notice given to committee members.

It should be noted that the court did not oppose the use of proxies in electing committee counsel, but, rather, the manner in which the proxies were used. The court denied the application to employ new committee counsel.

The court observed that if the members of the committee were truly interested in participating on the committee, they would have organized themselves by calling a meeting on reasonable notice at which time they would have selected their counsel and chairperson.

Creating Structure and Procedure: By-laws For Creditors' Committee

The ABC Automotive Products court observed that the failure of committee members to act created a situation where the interests of unsecured creditors were not properly represented. One way of enhancing the prospects for an active creditors' committee is by internal structure and procedures. This may be accomplished through the adoption of by-laws that deal with how the committee should operate. If members of a creditors' committee adopt by-laws, such as the form by-laws below, it should be easier for them to devote their attentions to the debtor's business and reorganization.

Committee Membership

(1) Ex Officio Members: Ex officio members shall have the rights and privileges of other members but shall not be entitled to vote on any matter before the Committee. The presence or absence of an ex officio member shall not be considered in determining the existence of a quorum or a majority for any Committee purpose.

(2) Attendance at Meetings: Meetings of the Committee or of any subcommittee may be attended by the duly authorized representatives and attorneys or members, including ex officio members, the secretary (if not a member), and professionals employed by the Committee, provided that, by majority vote of the Committee or subcommittee, any person may be invited to attend any meeting or portion thereof as the guest of the Committee or subcommittee.

(3) Representatives: Each member shall designate a representative and may designate an attorney to participate in Committee and subcommittee meetings, and to exercise all the member's powers.

(4) Proxies: A member of the Committee may authorize any other member of the Committee to vote on its behalf on any issue.

(5) Removal: The Committee may recommend that there is cause to remove a member where, by a two-thirds majority of the entire Committee, it finds that the member violated any confidentiality agreement; the member failed to disclose a conflict of interest; the member has failed to attend three consecutive meetings; the member is incapable of representing the interests of

Agenda

(1) To the extent possible, matters to be considered shall be presented to the Committee upon written agenda prepared by the chairperson wit the assistance of Committee professionals, and transmitted within 24 hours of Committee meetings. Any member may request that any item be added to an agenda for a scheduled meeting.

Action By Committee

(1) Powers and Duties: The Committee shall be authorized to take all actions permitted under the Bankruptcy Code, including but not limited to those powers and duties enumerated in Bankruptcy Code section 1103.

(2) Affirmative Vote:Action by the Committee at meeting shall require the affirmative vote of a majority of those voting.

(3) Action by Chairperson: Without prior Committee action or consent, the chairperson, with the advice of counsel for the Committee, shall be empowered to consent to or otherwise act on relatively minor Court matters between meetings, which may include (a) requests by any party in interest for the entry of court orders involving amounts not greater than $100,000 per item but not greater than $500,000 in the aggregate; and (b) other court matters not readily susceptible of monetary evaluation that, in the judgment of the chairperson, upon advice of Committee counsel, are considered to be in the normal course of business and not significant. The Committee shall be advised of any Court matters so acted on by the chairperson not later than seventy-two (72) hours after the action has been taken.

(4) Action by Chairperson Without a Meeting: In emergency situations, action may be taken by the chairperson on behalf of the Committee without a meeting, provided, however, that the determination by the chairperson is made, after consultation with Committee counsel, that such action is appropriate and provided, further, that the chairperson shall first make a good faith effort to poll the members of the Committee concerning the matter at issue.

Bylaws

(1) The bylaws are adopted only be a majority vote of the members. The bylaws may be adopted by facsimile signatures of the members.

(2) These bylaws may be amended only by the vote of a majority of the members.

1. 210 B.R. 437 (Bankr. E.D.Pa. 1997).
2. 210 B.R. at 442.

NO SECURITY AGREEMENT CREATED...UNLESS (Continued)

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In this case the creditors' committee for the bankruptcy estate used the Bankruptcy Code's "strong arm" powers to unseat the vendor's alleged lien. As a general rule, outside of bankruptcy, an unperfected security interest is binding between a debtor and vendor. The lack of perfection creates a problem for the alleged secured creditor only when an intervening third party obtains a perfected security interest that trumps the unperfected interest.

Upon a bankruptcy filing, a number of rights and powers are created for the benefit of the bankruptcy estate. Those powers include the ability of a trustee or debtor in possession to avoid the fixing of a lien on debtor's property --provided that the lien was not perfected prior to the commencement of the bankruptcy filing. This means that a debtor, or the creditors' committee here, may act as a hypothetical judgment lien creditor with the ability to unseat prior, unperfected liens.

Bargaining For A Security Interest

The court in CFLC, Inc. reminds vendors of the need for a signed security agreement to readily establish a security interest. In the absence of an expressly bargained-for security agreement, invoice forms that assert a lien on goods may not be sufficient to demonstrate that the debtor ever consented to terms granting the vendor a general lien.

1. 209 B.R. 508 (B.A.P. 9th Cir. 1997).

A HISTORY OF BANKRUPTCY PREFERENCES (Continued)

(continued from page 5)

To aid the trustee in establishing a prima facie case of preference, the drafters added the provision the debtor is presumed insolvent within 90 days prior to the bankruptcy filing.

d. Bankruptcy court jurisdiction

All forms of preference actions may be commenced in the bankruptcy court where, presumably, the action will proceed more swiftly.

e. Secret liens

Aimed at the secret lien, the Bankruptcy Reform Act also requires creditors to timely perfect their security interests.

f. Exceptions

The elimination of the creditor's state of mind element and the addition of the presumed insolvency of the debtor element broadens to scope of a preference. The drafters seek to limit the broadened scope with defined exceptions. Other than the "subsequent advance" exception, exceptions are new to preference law. The exceptions are intended to leave intact those transactions that do not diminish the size of the estate.

The drafters enumerated seven exceptions from section 547.
Courts have struggled with the application of the law, especially the exceptions, spending much time analyzing the ordinary course exception.

The drafters continued the rule disallowing a creditor's preferenced claim until the creditor surrenders the preference.

4. The 1984 Bankruptcy Amendments and Federal Judgeship Act *("BAFJA")*

BAFJA eliminates the "reasonable cause to believe" standard for insider creditors. The 45-day rule contained in the ordinary course of business exception is eliminated. BAFJA is contrary to the trend of more precise, bright line-rules promulgated under the Bankruptcy Reform Act. For example, the elimination of the 45 day reoccurrence rule now allows any creditor to argue the transfer was not in the ordinary course of business.

1. The article was originally published for the American Bankruptcy Institute's Preference Task Force Survey. A footnoted copy of the article is available upon request.

2. Id. at 473.

3. See Charles Jordan Tabb, Rethinking Preferences, 43 S.C. L. Rev. 981, 998 (1992).

4. 384, 385 (K.B. 1768).

5. 96 Eng. Rep. Barash v. Public Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981). Does this really promote equality? Creditors may hold on to the money knowing that so long as the debtor does not file 90 days after the filing they will be able to keep it. At worst, a preferred creditor will simply have to return the money.

RECLAMATION -- A PRIMER (Continued

(continued from page 1)

court the power to structure the debtor's affairs while at the same time protecting the innocent seller.

The Elements Of A Reclamation Claim

Courts have settled upon the following elements to establish a valid reclamation claim under the Bankruptcy Code:

(1) the seller sold goods on credit to the debtor in the ordinary course of business of both;
(2) the seller delivered the goods to the debtor at a time when the debtor was insolvent;
(3) the seller made a written demand for the return of the goods within ten, or in certain cases twenty, days after the goods were delivered to the debtor; and
(4) the debtor had possession of the goods at the time of the reclamation demand or the goods were not in the hands of a buyer in the ordinary course or a good faith purchaser at the time of demand.

Insolvency At The Time Of Delivery Of The Goods

The UCC's definition of insolvency is expansive. The UCC defines insolvency as an entity "who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning the federal bankruptcy law." The Bankruptcy Code, on the other hand, adopts only a balance sheet test to determine solvency. An entity is insolvent if "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."

Unfortunately for sellers, most courts have construed the Bankruptcy Code to require the customer to be insolvent within the more restrictive definition set forth in the Bankruptcy Code. Moreover, the point in time during which the seller must prove that the buyer's liabilities exceeded its assets is at, or after, the time of delivery.

Written Demand For Return Of The Goods Within 10 Days

The Bankruptcy Code, unlike the UCC, requires that the vendor's reclamation demand be made in writing. The written demand must be immediately sent to the buyer, preferably by facsimile, since it is likely that the effect of the reclamation notice will be measured by the date and time of receipt.

Some courts also recognize an exception to the 10 day rule where the buyer has made a written misrepresentation to the seller regarding its insolvency within the preceding 3 months. In this case a the requirement that the reclamation demand be in writing is overlooked by the court.

Possession Of Goods

Courts strictly enforce the requirement that the goods be in the possession of the debtor when it received the reclamation demand. If the debtor has transferred the goods to a good faith purchaser before the reclamation demand is made, the reclaiming seller loses all reclamation rights to those goods.

Enforcing Your Rights

Courts are divided as to whether a reclaiming seller may simply rely on a proper and timely notice, or must initiate an adversary proceeding, to enforce its rights. The risk the seller faces if it fails to seek court enforcement of its reclamation right is that it cannot meet its burden of proving that the goods subject to the reclamation demand were in the possession of the debtor at the time such demand was made.

Reclamation Where There Is A Secured Creditor

The rights of a reclamation creditor with respect to goods which are subject to a prior security interest has engendered much litigation. The issue arises by virtue of the fact that under the UCC, the seller's right to reclaim is "subject to" the rights of a buyer in the ordinary course or "other good faith purchaser under this Article."

Courts continue to struggle with the meaning of the phrase that reclamation rights are "subject to" the rights of the good faith purchaser/lienholder. One view is that the existence of a senior lien on goods merely subordinates the reclamation claimant's rights to those of the lienholder, i.e., it does not extinguish the supplier's right of reclamation. Those courts which have awarded administrative claims to reclamation creditors notwithstanding the value of the senior lienholder's collateral have done so on the grounds of "fairness."

On the other hand, some courts have determined that a secured creditors rights will extinguish all of the reclaiming seller's rights. It is important to note that a bankruptcy commencement may preclude any further security interest from attaching to the goods of the debtor. Therefore, only those goods that were sold to the debtor prior to the filing were subject to any security interest.

Reclamation may offer the vigilant credit executive a 100% recovery on certain types of claims. Although the circumstances in which reclamation rights are limited, the credit executive is invariably well advised to pursue this right whenever it is available.