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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

HOW CAN THIS BE! DEALING WITH A MAJOR CUSTOMER'S <u>SECOND</u> CHAPTER 11 FILING

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After much negotiation, you finally have an allowed administrative claim for your reclamation claim as your major customer's Chapter 11 plan of reorganization is finally confirmed. The plan of reorganization provides for the customer to continue to operate, albeit with significantly less debt. Your administrative claim comes at a price, as you agree to ship on credit to the "reorganized" debtor post-confirmation. Your company anticipates resuming significant sales to the reorganized debtor and supports resumption of credit terms.
The payment on your reclamation claim is over time, based on the reorganized debtor's cash flow. Payment on a percentage of your

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SAY GOOD-BYE TO "NSF": YOUR CHECK IS IN THE E-MAIL

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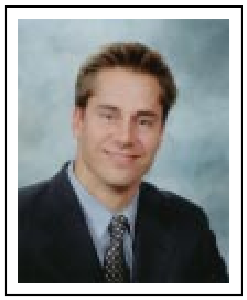

Your credit analysis concludes that a new corporate customer may be too much a credit risk and you insist on a COD sale. You authorize shipment with your delivery driver to pick up a corporate check from your customer with delivery of the goods. The goods are delivered, but when the corporate check from your customer is presented, it is returned "NSF". Your customer files bankruptcy. What could the vendor have done differently to avoid the "NSF" check? The vendor may have used a check guarantee service. The vendor may have had the salesperson pick up the check from the buyer, present the check for payment, and if it clears, release the goods. The vendor could also have looked to an electronic method of check payments to speed the sale and ensure payment.

With New Payment Technology, Say Goodbye to Bad Checks?

The technological revolution, in the form of the Internet, is not only changing the way in which vendors bring their goods to market, but it is changing the way in which vendors may be paid on their sale—and perhaps eliminating the bad check. Part of the speed of the payment revolution is recent legislation that recognize force of an electronic signature.

President Clinton recently signed into law the The Electronic Signatures in Global and National Commerce Act (The E-Sign Act). The E-Sign Act makes e-signatures as legally binding as ink-and-paper signatures, and can be used in legal proceedings. An e-signature is generally defined as a form of technology, including fingerprint readers, stylus pads and encrypted "smart cards", used to verify a party's identity so as to certify contracts that are agreed to over the Internet.

Some of the payment forms available to vendors to eliminate the risk of the bad check, depending on the type of business the vendor is involved, are:

E-Checks

Electronic version of a paper check. The e-check may provide for multiple payer, endorser signatures and is governed by the Uniform Commercial Code article covering checks. The customer may chose to have a third party accept the payments in an e-lockbox or have the receipt directed to the accounts receivable department for handling. E-checks use digital signatures, hardware tokens, duplicate detection, blinded account numbers, activation and current banking practices.

Guaranteed Checks

Software companies have developed websites that allow vendors to input checking account and payment information of a

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GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY

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Dot-coms, whether distributors or e-tailers, now proliferate the business community and provide a new opportunity for sales for vendors. However, as headlines highlight, liquidation is a growth industry for dot-coms. It appears that the name of the game for dot-coms, at least for the near future, is consolidation. Given the uncertain climate for selling to a dot-com and the fleeting value of the dot-com when it runs into financial difficulty, a vendor may be forced to act quickly when the dot-com unequivocally indicates it may not pay, or fails to pay, on the credit sale. While terms such as "race to the courthouse" and "dismembering the debtor" may have negative connotations to the fast-acting vendor, the nature of the dot-com's perishable value may require prompt action. What must the vendor do to get first in line?

A. The Fleeting Value Of A Financially Struggling Dot-Com Prompts Vendor To Act Quickly

The value of most dot-coms is intellectual property, such as customer lists, licensed technology and engineering teams. In comparison, vendors selling to a "bricks-and-mortar" company, such as a manufacturer, that runs into financial difficulty may act collectively and agree to support the company by consenting to an out-of-court workout that calls for a moratorium on payment of all vendor debt in an attempt to allow the debtor to work through its financial difficulties. Generally, not so for the dot-com. Vendors dealing with a dot-com that runs into financial difficulty usually cannot work together to support the dot-com because of its fleeting value. Further, the hallmark of an out-of-court workout is consensus with vendors. However, as the dot-com generally lacks sufficient assets and operating history, recalcitrant vendors may upend the out-of-court.

Underscoring the need of a vendor to act early when the dot-com fails to pay, or the vendor obtains information that the dot-com may not pay on its account, is that Chapter 11 bankruptcy is also generally not a viable alternative for a dot-com. If financing and merger efforts by the dot-com fail and it is forced to file an e-bankruptcy, it is probably already too late to preserve these assets for the benefit of vendors for a bankruptcy sale or reorganization.

In many cases, the going concern value is gone when key personnel are gone—-chasing stock options of another dot-com. With a dot-com Chapter 11, a creditors' committee, in which vendors act collectively, may not be appointed given the short duration of the case or lack of interest.

B. Getting First In Line When Your Dot-Com Fails To Pay

Given that a credit professional may be forced to act quickly when a dot-com has financial problems, what are the vendor's next steps to get first in line? Did the vendor provide goods or services? If the vendor provided goods to the dot-com, Article 2 of the Uniform Commercial Code provides the selling vendor with a number of remedies.

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FROM THE PUBLISHER:

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

Guest Column

DASHBOARD REPORTING

Art Goldman, CCE
Standard Yaesu

If you work – as do I – for a medium-sized company, your month-end experiences have never been pretty. In the typical chaos of the month-end crunch, how often have you truly looked forward to the ineluctable pleasure of producing management reports? Perhaps you have questioned, as have I, the actual value of the numbers you generate. And so perhaps you'll question my sanity if I suggest that a change of attitude may be in order. Sometimes bothersome duties can be converted into opportunities. The month-end reporting cycle can be used to your benefit. Let's explore how.

Our work is often judged by the way the aging looks; thus, the aging columns will monthly change, and so goes the stock of the credit manager. Thus, if the over-90 goes up two percent, you're that much closer to early retirement. Like you, I'd like to be judged on the totality of the handling of my department's affairs, not on one single number or measure. Mind you, one can't argue with the simplicity of using a single measurement, but when any, old, bad month end can mean a trip to an ICU, self preservation ought to dictate a somewhat different path.

It might be wise to here define the term, "Dashboard Reporting." The term, of course, refers to that most-familiar object, the automobile dashboard, which is engineered to give you everything critical to the operation of your car at a glance. I believe that's what month-end reports should do as well. Everything you or your bosses need to know should be easy to read and on a single page.

I have to thank a former boss, the CEO of a company, for coming up with the term. He wanted all of his managers to give a simple report at staff meetings. He wanted to know where we stood in comparison with the prior year, and how we measured up to the competition. Further, he wanted it in "dashboard fashion," meaning he wanted it in a

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WHEN YOUR BANKRUPT CUSTOMER FAILS TO COOPERATE: DEBTOR PRISON RETURNS?

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Your distributor customer that you've made a significant first-time credit sale refuses to respond to your e-mails and phone calls regarding the delinquent account. You suspect the debtor has provided you with false information on the credit application, including false references. Your salesperson's e-mail reports that the customer's warehouse is closed and the inventory apparently gone. You sense a bust-out or planned insolvency. Vendors file an involuntary bankruptcy petition under Chapter 7. You notify the interim bankruptcy trustee of your findings. The bankruptcy trustee investigates and prepares to question the debtor's principal regarding asset transfers. The principal fails to attend the First Meeting of Creditors, and refuses to attend the Rule 2004 examination set by the trustee. What can vendors do, in working with the bankruptcy trustee, to uncover assets, especially with a recalcitrant debtor?

A bankruptcy court in the *DFJ Italia* case recently directed local law enforcement to arrest a recalcitrant principal of a corporate Chapter 7 debtor for failing to appear at a First Meeting of Creditors and failing to attend a Rule 2004 Examination, so that the principal would appear at these examinations. The principal was suspected of orchestrating a scheme to defraud creditors and investors, although the principal had not been formally charged. Has debtor prison returned? This article focuses on the recalcitrant debtor in a Chapter 7 liquidation that may have orchestrated a bust-out, and methods vendors may obtain financial information about the debtor, including unusual transfers of assets that may lead to recovery and payment of vendors' claims.

The Bust Out

A bust-out is a scheme devised to defraud vendors of their goods through the use of planned insolvencies, bankruptcies and business failures. The bust-out operator obtains goods on credit purchases with the intent of not repaying the debts. Bust-out schemes are usually orchestrated in two stages. The first stage may be characterized as laying the groundwork for the bust-out and the second stage as execution.

In the first stage, the usual practice of a bust-out operator is to create a fake corporation (a fast, inexpensive task), establish a credit account with one or more vendors, make small purchase orders, and pay within invoice terms on the limited credit provided. In this way, the bust-out operator attempts to establish good credit, and credibility, with vendors. The bust-out operator often chooses a company name sounding much like a well-established company to further add credibility. Bust-out operators have found that having a Fortune 500 company as a reference can go a long way towards avoiding thorough credit checks.

Unsuspecting vendors of any size are vulnerable to bust-out schemes. The bust-out operator takes possession of the goods, then sells it at a steep discount — often to legitimate businesses. The cash from the sale is used to pay for prior orders, until it is time to execute the bust-out.

In the second stage of the bust-out, the execution, the operator places large orders on open account with as many vendors as possible. He or she then sells the merchandise at big discounts in return for immediate cash payment, and files for bankruptcy liquidation, or attempts to disappear with the cash. Vendors may join together and file an involuntary petition to force the debtor to disclose financial information about prepetition transfers.

Getting Information About Your Bankrupt Customer's Assets

The Bankruptcy Code and Rules provides several ways for vendors to obtain information about a debtor, including prebankruptcy transfers. Indeed, a bankruptcy

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TIPS FOR UNDERSTANDING YOUR CUSTOMER'S BANK CREDIT LINE

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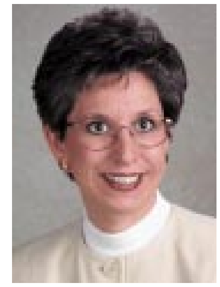
Moorhead Management Services



A bank credit line (also called a revolving credit facility) is a working capital loan. Your customer may have, for example, a $10 million line of credit with their bank. This means they have the ability to borrow up to $10 million and, up to that amount, may increase or decrease their borrowing on a daily basis. The amount borrowed under the bank credit line is included when calculating most leverage ratios.

When analyzing your customer's financial statement, it is important to understand how close the company is to reaching their maximum borrowing under the bank credit line. Also, looking at trends will help understand if, over a period of time, they are increasing or decreasing the overall borrowing.

Seasonal fluctuations go hand in hand with credit lines. It is typical to see the highest credit lines just before and during the busy season when a company builds inventory but has not yet collected the sales from the busy season.

However, if it is not the busy time of year and you see the customer being close to the total available on the line of credit, a red flag should go up. The balance sheet will show the amount borrowed. The total amount they can borrow under the bank credit line (called the availability) will probably be noted in the footnotes or management discussion. If your customer has borrowed their maximum in the non-busy season and will not have additional availability on the credit line when they need it, be aware they may stretch their payments to you to fulfill their working capital needs.

Even though a company may always have a certain level borrowed, in theory, a credit line is borrowed and repaid each day. There-

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SUPREME COURT TO REVIEW WHEN STATUTE OF LIMITATIONS RUNS UNDER THE FAIR CREDIT REPORTING ACT

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You pull a consumer credit report on the principal of the sole proprietorship business you are selling on commercial credit. You did not get consent from the consumer to pull the consumer report. You learn that the Federal Trade Commission recently issued a legal opinion concerning authorizations to pull consumer credit report under the Fair Credit Reporting Act (FCRA). You learn that the FTC views that a vendor extending commercial credit must obtain written consent from the consumer prior to pulling a consumer credit report for business purposes or for a personal guarantee of business credit. The United States Supreme, with the case Andrews v. TRW, Inc., has agreed resolve a conflict amongst the circuit courts to consider how long a consumer has to bring a claim under FCRA.

The FCRA

The FCRA regulates the use of individual credit reports and credit information. Generally the collection of business, trade, and commercial credit reports are not covered by FCRA. The FCRA insures that credit reporting agencies, and the users of such reports, will respect a consumer's right to privacy by pulling consumer credit reports only after express written authorization from the consumer.

The FTC's Legal Opinion

The FTC is a federal regulatory agency that enforces the provisions of the FCRA. The FTC views that a vendor extending commercial credit must obtain the consumer's consent prior to pulling a consumer credit report to be used for business purposes, or for a personal guarantee of business credit. The FTC states that a vendor must obtain the consumer's consent prior to pulling a consumer credit report. However, the FTC made clear the scope of the FCRA is limited to consumer credit reports: "we interpret it to mean that reports to business [vendors] by commercial reporting services such as Dun & Bradstreet, which compile data and provide such reports only for commercial purposes, are not covered by the FCRA." Opinion at p. 2.

The Statute Of Limitations Under FCRA

The FCRA provides that a consumer has two years in which the claim arises to bring an action under FCRA. But when does that time begin to run? When the vendor pulled the credit report without the consumer's authorization, or when the consumer learns that the report was pulled, which may be a significant lag? The Ninth Circuit Court of Appeals recently considered when the claim must be brought. The lower court held that the two-year statute of limitations began to run when the wrongful disclosures of credit information were made. The Ninth Circuit Court of Appeals reversed, applying the discovery rule. The Court of Appeals ruled that it is not until the consumer knows of the wrong, or has reason to know, that the two-year statute of limitations begins to run.

Penalties For Violating FCRA

The private enforcement provisions of the FCRA permit a consumer to bring civil suit for willful noncompliance with the FCRA, with no ceiling on punitive damages. The consumer may sue for negligent noncompliance, for actual damages sustained. The consumer may also seek to recover the consumer's attorneys' fees. In addition, criminal penalties may also be assessed including fines and imprisonment against any person who knowingly and willfully obtains a consumer report under false pretenses.

Supreme Court To Provide Guidance

The U.S. Supreme Court will soon provide guidance to the credit professional as to whether the statute of limitations begins to run when the wrongful credit disclosure is made or when the consumer knows or has reason to know of the act.

NEW LEGISLATION PROVIDES CONSUMERS ACCESS TO CREDIT SCORES: IS BUSINESS CREDIT NEXT?

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Federal statutes enacted to govern consumer transactions have recently been extended to commercial, or business, credit transactions. For example, the Federal Trade Commission (FTC) issued an opinion that the Fair Credit Reporting Act (FCRA), a federal statute enacted to protect consumers from the unauthorized pulling of credit reports, requires vendors extending business credit to obtain the express consent of a consumer before pulling a consumer credit report. Also, a federal court ruled that the Equal Credit Opportunity Act (ECOA), a federal statute enacted to protect consumers from creditors discriminating in the granting of credit based on a prohibited basis, governs business credit. With these recent extensions of federal laws intended to protect consumers being applied to business credit, credit professionals extending business credit must be mindful of recent legislation and cases intended to protect consumers may be applied to business credit. For instance, California recently adopted legislation, and like legislation is pending in the United States Congress to apply to all states, that requires creditors to reveal to applicants details of credit scores. Will this this type of legislation soon apply to business credit?

Legislation Disclosing Consumer Credit Scores Adopted

California recently adopted a law that requires lenders or creditors to tell consumers applicants the credit score used in any home-loan decision. Lenders also have to reveal the key reasons why the credit scoring was not higher. Presently, lenders are not required to reveal credit scores, which estimate an applicant's creditworthiness based on their credit reports. Under the new law, applicants may go to a credit reporting agency before applying for credit. Under

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HOW CAN THIS BE! DEALING WITH A MAJOR CUSTOMER'S SECOND CHAPTER 11 FILING (Continued)

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mid-six figure claim is also to be over time. Your company also receives stock in the reorganized debtor in exchange for its prepetition claim.

Notwithstanding all of the projections prepared by the debtor's accountants to confirm the plan of reorganization demonstrating the debtor would be profitable, it is not. Projections are missed and the debtor fails to pay on your administrative claim. The debtor also fails to pay on your post-confirmation credit sales. The debtor is chased by creditors and files a second Chapter 11 bankruptcy. How can this be? May a company file a second Chapter 11, also referred as a Chapter 22? Your major customer had spent two years in Chapter 11 and several million dollars on its attorneys, accountants and investment bankers to assist in paring down creditors' pre-bankruptcy debts, disposing of certain assets and repositioning itself in the marketplace.

Your customer had circulated a hundred-plus page disclosure statement and plan of reorganization to all of its creditors, supported by the creditors' committee and the bank group, coupled with pages of financial projections prepared by the debtor's Big 5 accountants detailing how the "new and improved" reorganized debtor would meet its trade obligations and return to profitability. The bankruptcy court found the plan of reorganization "feasible" and blessed the plan. You now realize that a confirmed Chapter 11 plan of reorganization, even supported with detailed projections showing your customer profitable, does not guarantee payment on your pre-Chapter 11 debts nor on your new shipments. What to do?

A number of companies have made headlines recently for their second Chapter 11 case, such as Montgomery Wards, Bradlee's, Crown Books, Converse, Inc. (tennis shoes) and LTV Steel Corporation (which was a Chapter 11 debtor for seven years). Indeed, TWA Airlines and Grand Union Supermarkets have each filed three Chapter 11's, and a number of companies are rumored in the press to be considering similar action.

Many of these reorganized debtors are in industries with strong competition, who could not meet their debt obligations and were forced again into Chapter 11 by their creditors. Notwithstanding years in Chapter 11, the extraordinary benefit of generally not paying pre-bankruptcy creditors, and a negotiated plan of reorganization that was supported by detailed projections of how the reorganized debtor would be profitable, such companies often failed to pare down their debt sufficiently in the first Chapter 11.

These companies defaulted on their confirmed plan of reorganization, and post-confirmation debts, followed by the filing of a second bankruptcy petition to obtain the automatic stay (an injunction that arises automatically upon the filing of the petition that enjoins creditors from collecting on their pre-petition claims) and a second opportunity to pare down their debts, and a likely orderly liquidation of the debtor's assets.

A vendor that has provided goods or services to these companies during the first Chapter 11 case, or after these "reorganized" companies have emerged from Chapter 11, likely face a write-off of their open account with the second Chapter 11 filing. The problem is that a company which has spent a number of years in Chapter 11 and confirmed its operating plan of reorganization, and some time out of it, may pose complex legal questions in determining which assets are part of the new bankruptcy estate, which claims may be entitled to priorities, and which transactions may be recovered under the avoidance powers created under the Bankruptcy Code, all of which may waste the assets available to pay vendors. The recent trend of some companies willingness to file a second Chapter 11 raises new questions—and poses new risks—regarding a vendor's strategy of credit sales to a company that is presently in Chapter 11, as well as one that has emerged from Chapter 11 (even years afterwards). A vendor may also questions whether it should accept payment on a reclamation claim over time in exchange for credit sales.

The Confirmed Chapter 11 Plan Does Not Guarantee Payment On Future Shipments

The primary purpose of a Chapter 11 case is the negotiation between a debtor and its creditors of a plan of reorganization which restructures the debtor's finances, provides the basis for repaying creditors and is the gateway through which a debtor emerges from Chapter 11. While a plan of reorganization takes many forms, typically the plan provides the company to continue to operate and pay vendors on their prepetition claim over time. The confirmation of the plan bars vendors from pursuing their preconfirmation claims and these claims are discharged and replaced by the new obligations specified in the plan. When the court confirms a plan of reorganization, it makes a determination that the plan is "feasible"; e.g. that the company is capable of meeting its obligations under the plan.

With large operating companies with many tiers of debt, determining whether a plan is feasible may take several days of testimony from financial experts. However, as the recent press reports indicate, confirmation of a Chapter 11 plan does not mean that vendors will be repaid according to the terms of the plan or that vendors furnishing goods on credit post-confirmation will not face bankruptcy risk. Once a plan of reorganization is "substantially consummated" (fully completed), it cannot be altered or amended absent a showing of fraud. Ordinarily, substantial consummation occurs when the plan goes into effect.

Bankruptcy Courts Generally Does Not Bar Second Chapter 11 Filings

The Bankruptcy Code does not expressly bar a company from filing a second Chapter 11, unlike an individual who files a Chapter 7 liquidation and obtains a discharge (which individual is barred from refiling for five years). Notwithstanding the Bankruptcy Code's absence of a bar on Chapter 22, bankruptcy courts that first faced whether an enterprise that filed a second Chapter 11 are eligible generally dismissed the case, forcing the reorganized debtor to liquidate its assets under the confirmed plan or convert to Chapter 7 liquidation.

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SAY GOOD-BYE TO "NSF": YOUR CHECK IS IN THE E-MAIL (Continued)

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debtor to guarantee payment. Other companies are producing electronic systems, which allow vendors to accept check information through the phone, e-mail, or the Internet and provide a more accurate method of getting payment and streamlining the check acceptance process. A vendor can get the number of their accounts and in the same day, through the software, a company produces a check ready for deposit, printed by its own printer and processed through the Federal Reserve System.

Electronic Bill Presentment and Payment

EBPP is a system by which customers can call up and authorize payment of their bills online, either through a direct banking link, or through a Web site. EBPP is reduced operational costs associated with a paper-based billing and remittance process. EBPP has become a popular payment method in part because the customer requires e-payment. With commercial accounts, proprietary sites may be set up.

EMoneyMail

The site provides for party-to-party payments and for companies sending rebates or refunds to their customers. Customers paying on their accounts go to www.emoneymail.com and choose whether to pay by credit card, debit card or checking account. Vendors get an e-mail that payment has been sent, click on an attachment with a link to the eMoneyMail site.

Credit Card

Vendors have embraced credit cards for payment on their commercial sales. Payment by credit card is appealing as it allows for payment prior to goods being released. However, a vendor may risk chargeback of disputed balances. The credit card company is not obligated to verify whether or not the dispute is legitimate.

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WHEN YOUR BANKRUPT CUSTOMER FAILS TO COOPERATE: DEBTOR PRISON RETURNS? (Continued)

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filing provides vendors with an opportunity to piece together a debtor's pre-bankruptcy transfers, and the bankruptcy laws, such as preference and fraudulent conveyance laws, may allow vendors to recapture these transfers. The Bankruptcy Code and Rules also provide for procedures to obtain financial information from a recalcitrant debtor, or the principal of the debtor.

Bankruptcy Schedules

With its bankruptcy petition, a debtor files its bankruptcy schedules of assets and liabilities, list of executory contracts and leases and statement of financial affairs. A court may extend the time to file schedules. The statement of financial affairs requires a debtor to respond to questions and lists the debtor's financial condition and asset transfers prior to the bankruptcy petition. The bankruptcy schedules and statement of financial affairs are signed under penalty of perjury. It is important for a debtor to provide an accurate schedule of assets and liabilities, as a debtor that intentionally files false bankruptcy schedules may be found to have committed a bankruptcy crime. If a vendor is dealing with a recalcitrant debtor that refuses to file schedules, the bankruptcy court may order a trustee to prepare them. A debtor that invokes the fifth amendment privilege against self incrimination may refuse to turnover financial information that would be used to prepare bankruptcy schedules and statement of financial affairs. Whether a bankruptcy court may have a debtor arrested to compel responses to questions regarding the debtor's financial condition may be unclear.

First Meeting Of Creditors

The Bankruptcy Code requires a debtor, or a designated representative of a corporate debtor, to appear at the First Meeting of Creditors and be questioned by the U.S. Trustee and creditors under penalty of perjury. In a Chapter 7, the bankruptcy trustee questions the debtor, along with creditors. With a corporate debtor, the court may designate its officers, directors or stockholders as the party to be examined. The debtor usually states the reasons for the bankruptcy filing and responds to questions as to the debtor's assets and liabilities. Creditors are usually only given a brief time to question the debtor. The bankruptcy trustee will recommend that a creditor conduct a Rule 2004 Examination for extensive questioning. A debtor may invoke the fifth amendment privilege against self incrimination at the meeting.

Rule 2004 Examination

A Rule 2004 examination of the debtor permits broad questioning into the debtor's financial affairs. The scope of the Rule 2004 examination may include the debtor's financial condition, property, assets and liabilities, and matters affecting the administration of the bankruptcy estate. The broad scope has been labeled a "fishing expedition". A vendor must get a bankruptcy court order to conduct such examination.

The Bankruptcy Court's Power To Jail A Recalcitrant Debtor

What if an individual debtor, or the principal of a corporate debtor, fails to attend the Rule 2004 examination or attend the First Meeting of Creditors, especially if the party is accused of orchestrating a bust-out. What may vendors do, in working with a bankruptcy trustee, to uncover assets?

In *DFJ Italia*, three creditors filed an involuntary bankruptcy petition against the debtor. The debtor was alleged to have orchestrated a Ponzi scheme. The bankruptcy trustee noticed the principal of the debtor for a Rule 2004 examination to obtain information regarding the debtor's assets and information regarding transfers of assets. The principal did not show for the examination. The First Meeting of Creditors was convened. The bankruptcy trustee designated the principal as the debtor. The principal did not show up. The bankruptcy trustee requested the bankruptcy court to issue a warrant for the arrest of the principal so that the U.S. Marshal could apprehend

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WHEN YOUR BANKRUPT CUSTOMER FAILS TO COOPERATE: DEBTOR PRISON RETURNS? (Continued)

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the principal. The principal had not been charged with any criminal activity associated with the business. The bankruptcy court agreed with the trustee, issuing a warrant for the arrest of the principal and charging the principal for willful evasion of service of the Rule 2004 examination and First Meeting of Creditors.

The bankruptcy court's order provided that if the principal was found outside 100 miles of the bankruptcy court, the principal was to be brought by law enforcement before the nearest U.S. Magistrate Judge, Bankruptcy Judge or District Court Judge. The court's order also provided that a bond hearing would be set, under Title 18 of the U.S. Code, commonly referred to as the bankruptcy fraud provision, wherein the court would establish the conditions of the principal's release. The principal was arrested and spent the night in jail. The next day the U.S. Marshal escorted the principal to a bankruptcy court hearing.

The bankruptcy court exercised its powers pursuant to Bankruptcy Rule 2005. That Rule provides that a party in interest alleging that an examination of the debtor is necessary for the administration of the bankruptcy estate and that the debtor is attempting to evade the examination, or has evaded service of the examination, the bankruptcy court may direct law enforcement, such as a marshal, to bring the debtor before the court. Where a debtor has failed to abide with the Rule 2004 examination order and meeting of creditors, such meetings constitute orders for examination which may be compelled under Bankruptcy Rule 2005. Rule 2005 also provides that a court may fix the conditions of a debtor's release, once apprehended, to assure attendance of the examination.

Working With The Bankruptcy Trustee, U.S. Trustee and U.S. Attorney To Uncover Assets

Besides the bankruptcy court, a vendor has other parties to assist with the asset investigation. The Bankruptcy Code grants the Chapter 7 trustee authority over all of the debtor's assets. The trustee is vested with the primary responsibility to undertake an immediate investigation into the debtor's assets and liabilities, including uncovering transfer of assets and misconduct which might have led to the bankruptcy filing. The trustee also has the obligation to institute litigation to collect assets of the estate. It is not for the vendors themselves, but rather the trustee, to pursue causes of action on behalf of the estate.

While the Bankruptcy Code clearly provides the trustee with broad powers to collect assets of the estate, there may be a conflict facing trustees: on the one hand, trustees are expected to handle cases more efficiently and to conclude cases more quickly, while on the other hand, trustees are still burdened with a large case load that does not permit them to devote time to properly investigate each case. Trustees are not employees of the government. Rather, they are attorneys, accountants or business people who are compensated as trustees by receiving a nominal flat fee for each no-asset Chapter 7 case they conclude, and, in asset-Chapter 7 cases with a distribution to creditors, a percentage of all money disbursed for each estate. The compensation structure does not provide an incentive to pursue assets where substantial investigation is required and recovery is speculative, as they take these types of cases essentially on a contingency.

Thus, to attract the trustee to pursue assets in a so-called no-asset Chapter 7, even a bankruptcy where a debtor is suspected of a bust-out, vendors may be required to fund the trustee's recovery efforts. Vendors must decide whether they are willing to spend "fresh" money to attempt to recover assets. This analysis requires a balancing of the value of the assets sought to be recovered (if known), after liquidation, with the estimated costs to locate and recover the assets. The difficulty with the analysis is determining "how deep the bodies are buried," e.g., how well has the debtor hidden the assets.

Another means of combating a bust-out is to refer the bust-out to the United States Attorney's Office and the Office of the Untied States Trustee. The U.S. Trustee is an adjunct of the Justice Department and has the responsibility of working with the U.S. Attorney's Office to investigate bankruptcy crimes.

NACM's Loss Prevention Department may also assist vendors in a bust-out. The Loss Prevention Department alerts members of questionable businesses or suspected frauds in progress, as well working with law enforcement agencies on behalf of members.

Answers To Unaccounted For Assets From The Bankrupt Customer

A bankruptcy judge will not stand for a debtor that does not comply with court orders and the duty to disclose financial information. A Chapter 7 debtor, or principals of the corporate Chapter 7 debtor, that may have orchestrated a bust-out may attempt to go "underground" to avoid investigation and refuse to cooperate with the bankruptcy trustee, vendors and the bankruptcy court. While using a criminal-type procedure in a bankruptcy proceeding and arresting a debtor for failing to attend a bankruptcy examination and Meeting of Creditors may be extraordinary, a bankruptcy court may use these powers to compel a debtor to cooperate. This may be an avenue for a vendor to consider if possibly ensnared in a bust-out and the debtor refuses to cooperate and provide financial information.

GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY (Continued)

(continued from page 2)

If the goods have been consumed, or the vendor has provided services, the vendor has a number of remedies under state law, and possibly federal law, to obtain a money judgment.

In considering the next step to obtain the goods back or payment for the value of the goods or services, the credit professional should review the credit file, sale's file and interview sales people responsible for the account. The credit professional should identify any disputes, accounting or credit issues or counterclaims in documenting the delinquent account. Below are some remedies available to the vendor. This list is not intended as an exhaustive list of remedies available to the vendor.

1. Uncertainty Of Dot-Com's Payment Prompts Demand For Assurance Of Payment

a. Right To Adequate Assurance Of Performance

Where the vendor has sold goods to the dot-com on credit and has grounds that the dot-com may not pay (termed "grounds for insecurity" under Article 2 of the UCC), the vendor may demand written assurance that the dot-com will perform. If the vendor receives no assurance from the dot-com within a reasonable time, or the assurances offered are not adequate, the vendor may suspend future deliveries. The two questions for the vendor with this remedy are whether the grounds for insecurity are reasonable, and whether the dot-com's assurance of performance is adequate.

b. Turning A Credit Sale Into A Cash Sale

Where the vendor has agreed to sell goods to the dot-com on credit, the vendor may refuse delivery and demand cash upon discovering that the dot-com is insolvent, as provided under Article 2 of the UCC. The UCC defines insolvent as either balance

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TIPS FOR UNDERSTANDING YOUR CUSTOMER'S BANK CREDIT LINE (Continued)

(continued from page 3)

fore, a credit line is usually shown in the current liability section of the balance sheet.

From time to time you may receive a financial statement that has the credit line in the long-term section of the balance sheet. They justify the long-term classification as always having a certain amount borrowed that would not be paid down in the next twelve months. If I find the bank credit line in the long-term liability portion of the balance sheet, I move it into current liabilities for analysis purposes (particularly when calculating the current and quick ratios). The reason for this is that industry standards for these ratios generally have statements with the bank line of credit in the current liability section.

If you do not move it from non-current liabilities into current liabilities for analysis purposes, the company's liquidity will look better than other companies in a similar situation. In fact, sometimes it will look real good when there may be liquidity problems that will be hidden because the bank line of credit is shown as a non-current liability. Classifying a credit line as a long-term liability is one way a company may try to make their statements look better.

Another thing to look at with the bank line of credit (and other borrowings as well) is the interest rate on the debt. If the borrowing rate is close to the prime rate, I assume this working capital loan is a standard risk for the bank. A red flag goes up if the rate is well above prime. Borrowing at a high interest rate means the company is considered a risky loan to their bank.

Many times you will receive financial statements without footnotes or management discussions. In these cases, the bank credit line is an excellent discussion point to use when you call your customer to discuss their financials. Asking questions about their banking situation can help open up communication on finding out what is really going on in their company. Discussing your customer's financials also lets them know you are analyzing the statements!

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DASHBOARD REPORTING (Continued)

(continued from page 2)

straightforward format and on a single page, so it could be easily seen through an overhead projector.

In developing this report, I had to reckon with two considerations. The first decision I had to make was what I would include in the report. Would I only reiterate information from the Accounts Receivable? Would I list various performance measures? What else could I include? What would I not include? The second major consideration would be how to organize this one-page wonder.

Taking my inspiration from the sources listed below, I began to construct the illustrated report. Since I wanted to convince management that we ought to pursue a more conservative approach to our collections strategy, I felt that I could probably make my case best by displaying our performance statistics. Sometimes arguments made in the abstract do not carry the weight of hard, cold numbers. I was right: once management saw the difference between the "Best-Possible DSO" and the regular "DSO," staffers began to think about all the cash tied up in the uncollected A/R.

Incidentally, it is ideal to also have a back-up plan for comparison reports, highlighting the benchmarking information. In this regard, one very important source is The Credit Research Foundation (CRF). This NACM-affiliated, educational foundation publishes quarterly statistics for eighteen different SIC classifications. Another, useful source is one's own trade group. If you can obtain the cooperation of other credit managers within that group, you may be able to get comparative statistics for your own use.

Since I've recommended a one-page format, how much information can be included? Quite a bit, as it turns out. Let's look at a possible format:

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DASHBOARD REPORTING (Continued)

(continued from page 8)

As Of 12/1/99

	Jan 1999	Feb 1999	Mar 1999	Apr 1999	May 1999
AGING					
Total Rec. $$ ($000)	5,000	5,000	6,000	7,800	4,000
Current $$ ($000)	4,000	3,500	3,300	5,500	3,500
Current %	80%	70%	55%	71%	88%
91+ $$ ($000)	600	550	550	550	400
91+ %	12%	11%	9%	7%	10%
PERFORMANCE					
DSO	65.2				
BPDSO	31.92				
CEI	66.50				
ADD	33.28				
SWDSO	60.2	59.8	63.2	63.1	61.3
CREDIT COST & ACTIVITY					
# Checked	17	7	12	13	20
% Declined	2%	1%	3%	2%	4%
Cost per Account	$21.50	$17.90	$31.20	$31.00	$ 9.50
Avg Days/Complete	4.4	3.8	2.7	4.9	2.2
BAD DEBT					
$$	$ -	$ -	$ 125	$ -	$5,200
% of Sales	0%	0%	0%	0%	0%
CASH FORECAST					
Estimate	2,995	3,195	3,225	2,985	3,985
Actual ($000)	3,295	4,195	3,700	5,100	4,555
Mo. Collection Ratio	51%	32%	49%	46%	34%

Please note that I've made up all the numbers in this excerpt, and that it's supposed to report on a full thirteen months. Note that, taking my cue from CRF, I've reported DSO, BPDSO, CEI, etc, on a quarterly, rather than a monthly, basis. This is important, because whether management is interested in comparisons with benchmarking sources, you ought to be. As CRF's information is available only on a quarterly basis, I chose to report in the same manner. Whatever your personal preferences, from this segment, it should be possible for you to construct your own version in Microsoft Excel, or whatever spreadsheet software you prefer.

Each section of the above is excerpted from a separate report, so that should more detail be preferred, further back-up can be provided. I do not make it a practice to include more information than I need in order to make my case. I would be willing to provide sample, back-up reports to interested parties. Space here precludes illustrating all of them.

The first section of the sample comes from the actual Accounts Receivable report, generated monthly on the company mainframe. While management may want more detail, I have found most employers can live with just the current and over-90 columns, plus their percentage of the total A/R. This allows a quick and easy comparison of prior months and (in the real, thirteen-month version) the prior year, of course.

The "Performance" section uses the same measurements that appear in the quarterly sampling done by CRF. Obviously, you can use another source else for benchmarking, but I found CRF a good source. Selection of a source to use for benchmarking is important. Some sources may be more specifically geared to your company and its niche, so chose wisely. This subject, explored fully, could easily earn one an MBA; space here prohibits a more detailed discussion. By the way, the "SWDSO" does not come from CRF, it comes from the Gallinger paper listed below (see sources). It stands for "Sales-Weighted DSO," and it is a measure that I have found to be pretty useful in the past. Management chose to see it monthly, although I would have preferred to do it only quarterly. Gallinger is an advocate of it, since he claims it reduces the "sales bias" which he points out reduces the effectiveness of nearly all, popular performance measures. For a full discussion, see Gallinger.

"Credit Cost and Activity" refers to the credit clearance efforts of my department. Here, I report the number of credit applications I processed in the prior month and relate the costs incurred in doing so. I also show the average number of days it took to set up an account, from date of receipt in my department to the date of the final credit decision. The percent declined result is particularly important for judging the strictness of your credit policy; if too many accounts are declined, you may need to revisit your decision methodology.

The "Bad Debt" segment is probably self-explanatory. I've expressed bad debt as a percentage of monthly sales, but you could use any yardstick you like. One enhancement might be to express it as a cumulative percentage of sales, allowing you to project your likely trajectory toward year-end.

The final segment is the infamous cash forecast. I don't want to go here, because it's a book-length subject. Suffice it to say that whatever method you use, calculating a collection ratio should take but a few moments, and provides yet another measure of historic activity.

Good luck in your search for the best month-end reporting format!

Sources:

Christie, George N. and Albert E. Bracuti. *Credit Executives Handbook*. Columbia: CRF, 1986.

Gallinger, George W. "An Evaluation of Techniques for Monitoring Accounts Receivable." Columbia: NACM, 1995.

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HOW CAN THIS BE! DEALING WITH A MAJOR CUSTOMER'S SECOND CHAPTER 11 FILING (Continued)

(continued from page 5)

These courts expressed concern that permitting debtors to file a second Chapter 11 was an attempt to circumvent the claims of the creditors who had participated in the first Chapter 11. These courts also expressed concern that allowing a debtor to circumvent the provisions of a confirmed plan could dissuade creditors from working with a financially strapped debtor, especially those that had furnished goods on open account during the Chapter 11. These courts noted a second plan, if confirmed, could discharge the obligations created in the first plan, including priority claims, and the potential loss of priority status in the second case could dissuade creditors from providing postpetition trade credit.

The modern trend of bankruptcy courts, however, is to permit a company to file a second Chapter 11 petition, as opposed to forcing the company into an involuntary dismissal of the bankruptcy petition or conversion to Chapter 7 liquidation. These courts reason that the costs and creditors involved benefit more from a second Chapter 11 filing, than liquidation alternatives under Chapter 7 or state law. Often the two Chapter 11 filings are for different purposes, with the first Chapter 11 filing intended to reach a consensual plan of reorganization, while the second Chapter 11 filing is for a partial, or complete, liquidation of the company, with assets sold off to satisfy the secured creditor. While courts recognize the concern that vendors may sell on credit post-confirmation if there is perceived a risk of a second filing, courts refuse to dismiss a case on these grounds.

Risks Posed to the Vendor

As recent press reports indicate, even if an enterprise confirms a plan of reorganization that proposes to pay vendors overtime, there is no guarantee the enterprise will still not return to financial straits and file a second Chapter 11. Vendors may be at risk under this recent trend. For debtors and creditors to cooperate in Chapter 11, Congress saw fit to maintain checks and balances between the parties. This is done, in part, by granting vendors that sell post-bankruptcy on credit a higher priority of payment than prepetition unsecured creditors, should a debtor fail to pay. A second Chapter 11 may strip the vendor of this priority.

Likewise, the filing of a second Chapter 11 poses special risks to prepetition unsecured vendors that are offered under the first plan of reorganization terms that allow vendors a more favorable payment on their unsecured claims should they supply the debtor on credit after the plan is confirmed. A second Chapter 11 filing would treat these post-confirmation credit sales to the same priority status as other unsecured creditors. The willingness of companies to file a second Chapter 11 also raises the question of whether vendors should negotiate during the first Chapter 11 for payment terms under the plan of reorganization that excludes the payment of stock and instead press for payment in the form of a note. While vendors may seek stricter provisions in a Chapter 11 plan governing the liquidation of the debtor in the event of a post-confirmation failure, in reality a second filing would wipe any stricter provisions.

The recent trend of companies' willingness to file a second Chapter 11 poses new risks to the credit professional. Perhaps the strongest reminder for the credit professional is that notwithstanding a reorganized or reorganizing company's assurances, supported by statements and projections prepared by its financial consultants that it has restructured its balance sheet, shed its unproductive assets and repositioned itself in the marketplace, there is the risk of a second Chapter 11 filing. Recognizing this, a credit professional may re-evaluate whether credit should be extended to these companies, both during and after Chapter 11.

SAY GOOD-BYE TO "NSF": YOUR CHECK IS IN THE E-MAIL (Continued)

(continued from page 6)

The vendor may be responsible for unauthorized purchases and fraud. A vendor may accept a personal credit card for a commercial sale, however it may be an indicator that the company the person is purchasing for is in financial trouble. However, it may mean that the person wants the frequent flyer miles. Credit card transactions conducted by telephone, fax or the internet, also known as card-not-present transactions, have a higher risk of fraud.

Virtual Credit Card

Customer can use a credit card online without giving their actual credit card number. Credit card issuer has customer download software that gives a one-time credit card number for the purchase. Vendor does not get the real credit card number.

CD Credit Card

Customer puts CD Credit Card into computer's CD-ROM drive. The software company contacts customer's bank for authorization, then sends an authorization number for payment processing to the online vendor. Vendor never has customer's credit card number. The CD Credit Card needs a password to be activated, thereby reducing the risk of fraud and unauthorized use.

Digital Cash

Web version of a phone card, which is currency that is only accepted on the Internet. Retailers download software that accepts the currency and customers download. Costumers purchase it with real money and vendors receive real money in exchange.

Virtual Points

Similar to frequent flier miles where users earn virtual currency. Some companies offer users the option of "cashing in" their currency points into their checking accounts or credit cards.

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SAY GOOD-BYE TO "NSF": YOUR CHECK IS IN THE E-MAIL (Continued)

(continued from page 10)

Party-to-Party Payment

A way to send money through the Internet to a vendor who does not accept credit-cards payments. It is similar to an escrow account. The customer sets up an account with a credit card number attached and the vendor picks up the money by visiting the Web site.

Virtual Escrow

A third party ensures that the customer receives the item and the vendor receives payment. Both parties agree to use same service before their transaction and the customer sends payment using a credit card, check or bank transfer through the service. The escrow service verifies payment and then the vendor ships.

Digital Wallets

Customer downloads software that stores their credit-card number and other information. Vendor downloads the same software to receive payment. The wallet stores shipping and billing addresses as well as credit-card numbers.

Bad Check Laws Still A Remedy When Don't Receive E-Payment

While a vendor welcomes electronic payment over the risk of a traditional check, some customers will not go electronic thereby creating the risk of NSF. But bad check law provides some protections to a vendor. Bad check law is governed by state law, not federal legislation. All states have bad check laws. Each state may have different statutory provisions as to whether a party may be guilty of a crime and may be subject to civil penalties. Bad check law combats the principle of deception: the buyer of goods or services deceives the vendor into believing that payment is made, and the vendor releases the goods in reliance on such representation.

Generally, a vendor is required to establish the buyer's intent to defraud and knowledge of insufficient funds for a valid claim under the bad check laws. Most states provide that it is prima facie evidence of insufficient funds if: (a) the check was not honored, and (b) the buyer did not pay the check after written notice of dishonor of the check. Under the bad check laws, a vendor may have claims against the buyer on a civil basis (collection of the debt) and a criminal basis.

When the check is dishonored, a vendor has a claim for breach of contract. The vendor may also have a claim for fraud and check deception. The supposed buyer of goods without the intent to pay may constitute fraud. The purported purchaser's silence on this fact may constitute fraud, if such information is not reasonably available to vendor. A vendor may sue for the amount of check that was dishonored, treble damages and up to $1,500 plus attorneys' fees and costs. A vendor should send a demand letter for payment to the buyer advising of treble damages and an opportunity to cure the bounced check within 30 days.

A buyer may have defenses to the bad check. One defense the buyer may assert is a good faith dispute defense. The basis for this defense is that the goods or services were not as promised. The rationale for the exception is that a vendor cannot coerce the buyer into paying a bill which is unjust or which the buyer, in good faith, disputes. Another defense asserted by the buyer to the bad check is the representative capacity defense, i.e., the check maker was an agent or conduit. Other defenses to the bad check are that the contract is illegal and the buyer does not have the capacity to contract.

New E-Payment Alternatives Reduce Risk Of Bad Check

With the alternative payment schemes now available for vendors to ensure payment of their commercial sales, the "NSF" check is becoming less relevant. Central to the e-credit department is accelerating the cycle to make a credit decision and payment on the sale. The various payment mechanisms accelerate the payment cycle while reducing the risk of loss.

NEW LEGISLATION PROVIDES CONSUMERS ACCESS TO CREDIT SCORES: IS BUSINESS CREDIT NEXT? (Continued)

(continued from page 5)

the new law, applicants will also know what factors affect their credit scores and how to achieve a better credit score. The law is effective July, 2001.

Current Disclosures To Applicants Denied Business Credit

Given the recent interest by state legislatures and the U.S. Congress in requiring disclosure of credit information for consumer applicants denied credit, what is the present disclosure requirements imposed on credit professionals for applicants requesting business credit?

Disclosures Under the Equal Credit Opportunity Act

Under ECOA, a credit grantor must provide notice to the applicant of denial of credit, or an adverse action, taken with the request for credit within 30 days after a completed application is received by the credit grantor. The credit professional's letter states that the applicant may be provided with a statement of reasons why credit was denied within 60 days of the date of the letter. If an applicant requests an explanation for denial of within 60 days, the credit grantor is to provide a statement of reasons within 30 days. What information must the credit professional provide? ECOA does not require the credit professional to provide specific reasons for denying credit, but instead may provide language such as, "adverse credit history"; "lack of business experience"; "lack of working capital"; or "too much secured debt."

Unlike the legislation recently adopted in California for disclosing consumers credit information where the creditor must provide reasons for declination, ECOA does not require such specific disclosure.

Disclosures Under the Fair Credit Reporting Act

The FCRA requires that a credit grantor

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NEW LEGISLATION PROVIDES CONSUMERS ACCESS TO CREDIT SCORES: IS BUSINESS CREDIT NEXT? (Continued)

(continued from page 11)

provide notice to the consumer if the credit grantor is denying credit, or otherwise taking adverse action with respect to the credit application, based upon the information obtained in the credit report. Thus, a credit grantor will provide notice to the company of the denial of credit; the credit grantor must also provide notice to the president, shareholder or guarantor with respect to whom the credit report was obtained.

The notice can be oral, in writing, or electronic. The credit grantor is required to provide the name, address and telephone number of the consumer reporting agency. In addition, the credit grantor must state that the consumer reporting agency did not make the adverse credit decision and such agency is unable to provide the consumer with the specific reasons why the adverse credit decision was taken. Finally, the credit grantor must notify the consumer of the consumer's right to obtain a free copy of the consumer report. Notice must also be provided of the consumer's right to dispute with the consumer reporting agency the accuracy or completeness of any information in the consumer report.

Applying Consumer Legislation To Business Credit Transactions

How can a federal court in analyzing the ECOA, and the FTC in considering the FCRA, conclude that legislation intended to govern consumer credit apply to commercial credit transactions? Look to the statutes. ECOA and FCRA's broad definitions of "creditor", "applicant" and "credit transaction", for example, the court in analyzing ECOA, and the FTC in considering FCRA, could reasonably conclude that the FCRA and ECOA governs business credit as well as consumer credit. The United States Supreme Court has held that in interpreting a federal statute, courts are to give effect to a statute's plain meaning.

Vendors Vigilant To Consumer Law Developments

Given state legislatures and the U.S. Congress inclination to broadly define terms with consumer legislation, and the trend of courts and regulatory agency to liberally apply consumer legislation to business credit, credit professionals extending business credit should keep an eye on developments with consumer laws. It may be that the consumer legislation applies to business credit.

GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY (Continued)

(continued from page 8)

sheet insolvent (liabilities exceeds assets) or fails to meet debts when they become due.

2. Getting Your Goods Back

Where a vendor has shipped goods, as opposed to providing a service, a vendor's strategy when a dot-com fails to pay depends on when the goods were shipped.

a. Stopping Goods In Transit

Under Article 2 of the UCC, a seller may stop goods in transit in two instances, where the debtor is insolvent or where the buyer repudiates or fails to pay prior to delivery. However, once the goods have been received by the buyer, the right of stoppage is lost.

b. Reclamation

If the dot-com has received the goods, the vendor's right of reclamation may be available to recover the goods. Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The remedy of reclamation is needed when the vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud. A vendor must establish the goods were sold on credit while the dot-com was insolvent. The vendor must also make 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 the debtor had possession of the goods at the time of the reclamation. Reclamation is a state law right that does not require a dot-com's bankruptcy filing.

C. Collecting On Your Delinquent Account

If the vendor seeks a money judgment against the dot-com, consider the following. Of course the credit professional should consider the collectability of any judgment against the dot-com. There should be a review of available assets to satisfy a judg-

(continued on page 13)

GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY (Continued)

(continued from page 12)

ment and a UCC search to determine whether there are any preexisting secured creditors, and the effect of other creditors' actions to collect against the dot-com or block the vendor's collection efforts.

1. Claims Against The Dot-Com

a. Breach of Contract, Conversion And Fraud Claims

With the typical dot-com credit sale, the dot-com will have completed the vendor's credit application. The dot-com sends a purchase order for goods or services. The vendor invoices the dot-com and ships for provide the service. The credit terms are, say, 15 days. The dot-com fails to pay. The vendor has a breach of contract claim against the dot-com for failing to pay, absent a legal excuse. If the dot-com has misrepresented its intention of paying for the goods or services, the vendor may have a claim for fraud against the dot-com, and perhaps officers of the dot-com.

b. Provisional Remedies For The Vendor

i. Writ Of Attachment

In addition to filing a lawsuit to collect on the delinquent account, a vendor may move to attach a dot-com's assets prior to a final determination of the claims sued on. The attachment creates a lien on the dot-com's property, and the vendor may have certain property of a dot-com seized before judgment and held by a levying officer for execution after judgment to protect the vendor's priority. The theory is to preserve collateral and obtain a lien that is not voidable after 90 days.

The practical use of a writ of attachment is for settlement and may prevent prolonged litigation.

ii. Claim And Delivery

A vendor holding a security interest in personal property of the dot-com may move a court to recover possession of the property before judgment. The vendor must know the location of the collateral.

2. Finding Another Pocket For Payment

The vendor may consider another pocket for payment even where first in line for payment against the dot-com's assets, as the dot-com may have insufficient assets to pay the delinquent account, or satisfy a money judgment.

a. Claims Against The Dot-Com's Insiders

The vendor may consider whether claims may exist against the dot-com's officers, directors and shareholders.

i. Breach Of Personal Guarantee Claim

Where the dot-com has breached the contract and the vendor obtained a guarantee from one of the dot-com's insiders, the vendor may look to collect against the guarantor.

The basic legal principle is that the guarantor is not a party to the principal debt. The guarantor's undertaking is independent of the dot-com's promise to pay. Merely because both contracts are on the same paper, for example, the credit application — the dot-com's promise to pay for the vendor's goods or services, and the guarantor's promise to pay if the dot-com does not — does not change the independence of the agreements.

The language in the guarantee should clearly state that the particular individual signing the guaranty is agreeing to answer for the debt of another. The guaranty should include a statement that the signing party is personally guarantying the debt of the dot-com referenced in the credit application. The guaranty should have under the signature block a line for the individual guarantor's social security number and a line for the individual guarantor's home address. The guarantee should be signed before a notary to reduce the risk that guarantor may contend that the guarantee was forged. A dot-com often receives investments from deep-pocketed venture capitalists. If the vendor is a key supplier, the vendor should demand the venture capitalist guarantee the sale.

ii. Piercing The Corporate Veil Claim

A court may disregard the corporate shield and hold shareholders personally liable for the dot-com corporation's debts upon a showing of certain factors. Those factors include the dot-com corporation's separate identity is not honored, a commingling of the dot-com's funds for personal use, a failure to observe corporate formalities and a failure to contribute capital. A vendor must also establish that injustice would result if corporate shareholders escape liability. The alter ego liability is most commonly applied where the corporate dot-com has few shareholders.

iii. Preference Claim

Did the dot-com's officers and directors receive extraordinary bonuses or other compensation that drained assets from the dot-com that should have been used to pay vendors? Federal bankruptcy and state preference laws are intended to treat parties of the same priority equally. To that end, extraordinary transfers to insiders may be recaptured up to a year prior to a bankruptcy filing, while the dot-com was insolvent. Generally, this claim is pursued by a creditors' committee or bankruptcy trustee, in a Chapter 7.

iv. Fraudulent Transfer Claim

A vendor may avoid two forms of transfers by a dot-com that are fraudulent as to vendors: (1) the intentional fraudulent transfer, wherein the dot-com transfers assets with the intent to hinder, delay or defraud its creditors; (2) the constructive fraudulent transfer, wherein the dot-com transfers assets for less than reasonably equivalent value while it was in financial straits (such as insolvency at the time of transfer, had unreasonably small capital as a result of the transfer, or incurred debts beyond its ability to repay by virtue of the transfer).

Both the intentional and constructive fraudulent transfer provisions are part of the Uni-

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GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY (Continued)

(continued from page 13)

form Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act. Each state has adopted a variant of these Acts. In certain states under the Uniform Fraudulent Transfer Act, an intentional fraudulent transfer may be avoided up to one year after the transfer. A vendor need not establish that the dot-com was in financial straits at the time of the transfer.

In certain states under the Uniform Fraudulent Transfer Act, a constructive fraudulent transfer may be avoided up to four years (and possibly seven years) after the transfer. The policy supporting the constructive fraudulent transfer is that a debtor may transfer assets for any value while it is financially healthy and paying its creditors. It is where the debtor is in financial straits and creditors will not be paid in full, may the transfer be attacked as one where the transfer did not yield fair value for the asset. Generally, this claim is pursued by a creditors' committee or bankruptcy trustee, in a Chapter 7.

v. Breach Of Fiduciary Duty Claim

The officers and directors of a corporate dot-com owe fiduciary duties to the vendors when it is insolvent, as the shareholders' interest is lost. These fiduciary duties are a duty of due care (exercise of proper judgment) and the duty of loyalty (not take advantage of corporate opportunity). Approval of a dot-com's board of directors of a liquidation sale may expose the officers to personally liability for failure to maximize the dot-com's value and breach of its fiduciary duty. With a publicly traded dot-com, there may be D&O insurance available to cover these claims.

vi. Illegal Dividend Claim

A state may have legislation that bars an insolvent dot-com from making a distribution to shareholders while insolvent. If a dot-com's shareholder, such as a venture capitalist, received such payment it may be recaptured for the benefit of creditors. The theory is that such a distribution circumvents the state law priority scheme that a creditor is paid prior to a shareholder with an insolvent company.

vii. Equitable Subordination Claim

Do the dot-com's owners hold unsecured claims for supposed "loans" to the dot-com? The shareholder "loans" may be reclassified as shareholder contributions and subordinated to vendor claims. The legal doctrine of equitable subordination may provide for a subordination of the insider's claim. Equitable subordination is unique to the Bankruptcy Code. Courts commonly look at three factors to support equitable subordination: (1) the claimant engaged in some form of inequitable conduct; (2) the misconduct must have resulted in injury to he creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the clam must not be inconsistent with the provisions of the bankruptcy laws. This claim is used to leap frog ahead of the shareholder for payment. It does not seek payment from the shareholder.

b. Claims Against Third Parties

i. Fraud And Negligent Misrepresentation Claim

Finding *reliable* historical financial information as well as forecasts for future operations of a dot-com can be difficult. The usual sources of public and private financial and credit information that a credit professional may consider, often do not have meaningful information on the dot-com. The credit professional may consult with members of his or her credit industry group, or vendors of the dot-com not provided as references. The credit professional may also contact the venture capitalists who invested in the dot-com, the owner who invested in the dot-com or the bank that has financed the dot-com for information.

Suppose one of these parties managing the dot-com's account provides the credit professional statements regarding his or her belief the dot-com's assets are sufficient to cover the vendor's credit sale to the dot-com. The dot-com fails to pay. Does the vendor have a claim against the investor or bank for fraud or negligent misrepresentation for the statements?

With the dot-com shakeout, venture capitalists of the dot-com, in particular, may be exercising more direct participation in hopes of preserving their investments. This may lead to potential claims by vendors if they are not paid on their credit sale. However, courts are reluctant to impose liability on third parties, such as venture capitalists, based on causal remarks or speculative future performance predictions. Similarly, a court may question whether a vendor justifiably relied on statements by a third party unless they are supported by material financial information necessary for an informed business decision.

ii. Joint Venture Claim

Venture capitalists of the dot-com may be exercising more direct participation in hopes of preserving their investments. Does this participation between the venture capitalist and the dot-com create a join venture claim by the vendor against the venture capitalist, wherein the venture capitalist was unjustly enriched because of the vendor's sales?

The basic rule of a joint venture is an undertaking by two or more entities, with or without a corporate or partnership designation, formed for carrying out a particular transaction. The parties agree to share losses and profits, and combine their property, money, efforts, skills, or knowledge in a common undertaking. The parties must also jointly participate in the management and control of the business. Under this theory, a vendor may contend that the venture capitalist has obligated itself to pay for the goods or services.

iii. Restitution Claim

If the dot-com has a lender that purports to have a security interest in the dot-com's inventory, including after acquired inventory, the so-called "floating lien", the lender may foreclose upon the dot-com's default and sell the dot-com's inventory to satisfy its secured claim. Under limited circumstances a vendor may have a cause of action against the lender to recover the value of its goods. Courts look to either inequitable conduct by the lender or the nature of the vendor's contribution to the collateral. Where a lender encourages transactions

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GETTING FIRST IN LINE WHEN YOUR DOT-COM FAILS TO PAY (Continued)

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between the debtor and vendor and benefits from the merchandise, there may be an opportunity for the vendor to unwind the transaction. If the lender had an active hand in promoting the vendor's sale to the dot-com, courts reason that the lender should not escape when a vendor is left without. A vendor may have a claim that the lender was unjustly enriched.

The more difficult issue for courts may be the lender's acquiescence when a vendor provides goods to the dot-com. When a vendor provides goods or a service that is necessary to preserve the collateral this is an expense the lender would ordinarily incur as part of its duty to maintain the collateral.

In these situations, the lender directly benefits and a vendor's claim for restitution may stick. However, it becomes less clear for a vendor when its merchandise or service is not essential but merely useful. In this sense the collateral available to the lender for liquidation is merely being made more accessible. In these situations courts are reluctant to disrupt the transaction out of concern that a favorable ruling to a vendor could encourage swarms of litigants to challenge what may otherwise be clear rules contained in Article 9 of the Uniform Commercial Code.

Thus, courts are reluctant to upset the priorities scheme provided under Article 9, and the predictable system of creditor priorities that it provides. A secured creditor is entitled to payment before a vendor who has not complied with Article 9, and generally has the right to take possession of and sell the collateral if the dot-com defaults.

iv. Auditors "Going-Concern" Clause Misleading

A vendor's due diligence of the publicly traded dot-com usually includes analyzing the dot-com's annual financial statements. Were these financial statements prepared by the dot-com's auditors on the presumption that the dot-com is a "going-concern"; in other words, that the dot-com will continue for at least another 12 months? But weeks after the vendor's credit sale, the dot-com files bankruptcy. An auditor is to disclose that if there is substantial doubt about a client's ability to continue as a going concern, this is to be disclosed in the dot-com's financial statements. If the auditor does not make the "substantial doubt" disclosure, this does not assure the vendor that the dot-com will be around for a year. However, the auditor is responsible for identifying key points that may raise whether the dot-com may survive, such as sufficient capital to continue to operate. It certain circumstances, vendors that relied on the auditor's financial statements in deciding to ship on credit may have claims.

v. Beating The Secured Creditor: Avoidance Powers Claim

Upon a bankruptcy filing, a number of rights and powers are created for the benefit of unsecured creditors. Those powers include the ability of a trustee, debtor in possession, or creditors' committee in appropriate circumstances, to avoid the fixing of a lien on a debtor's property. The avoidance powers may allow for unseating a lien not properly perfected prior to the commencement of the bankruptcy filing, as well as a lien that was properly perfected but recorded during the preference period.

As a general rule, outside of bankruptcy, an unperfected security interest is binding between a debtor and vendors. Thus, a secured creditor has priority over unsecured vendors even if the creditor has not strictly complied with the state (Article 9 of the UCC, of example) or federal statutory scheme to perfect its claim. 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.

This means that upon the bankruptcy filing, a debtor, or a creditors' committee (in Chapter 11), may act as a hypothetical judgment lien creditor with the ability to unseat prior, unperfected liens. With the assignment of the avoidance powers by the debtor or trustee, a creditors' committee may use the "strong arm" powers to unseat the creditor's alleged lien.

A creditor's lien may also be avoided even if properly perfected but recorded during the preference period, in certain circumstances. The Bankruptcy Code's preference law, which is part of the avoidance powers, provides for the recapture of payments made to creditors within the 90 days prior to a debtor's bankruptcy filing. The preference law also provides for unseating a creditor's lien recorded during the preference period in certain situations.

c. Claims Against Buyer

i. Sale Of Assets In And Out Of Bankruptcy

Where a dot-com sell its assets outside of bankruptcy and the vendor is not paid, the vendor may have claims against the buyer for unjust enrichment, as the dot-com benefited from vendor's goods or service and from the sale of its business.

The Bankruptcy Code provides that a company may buy the assets of the bankrupt company without taking its debts. Because a buyer is protected from the bankrupt debtor's creditor with an asset purchase, Chapter 11 has become a popular method for buyers to purchase assets.

d. Solutions

Given the lack of alternatives for an insolvent dot-com, the vendor may be forced to act quickly if a dot-com fails to pay, or there is concern that the dot-com may not perform. The above remedies are a starting point for a vendor to get first in line for a dot-com's assets, or, possibly, claims against a third party.

Given the speculative value of a dot-com once it runs into financial difficulty, the vendor may look to have the dot-com post assets, or provide other forms of security to reduce or eliminate the risk of non-payment. My article "GUARDING YOUR SALES TO THE DOT-COM WITH CREDIT ENHANCEMENTS: DON'T LET YOUR INVENTORY END UP ON A DOT-COM LIQUIDATORS WEB SITE!" discusses various credit enhancements that a vendor may take advantage of, from letters of credit, to certificate of deposit's to insurance to consignments, to eliminate or reduce the risk of a credit sale to a dot-com.

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