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THE TRADE VENDOR QUARTERLY

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

CHAPTER 11'S ON THE RISE: RED FLAGS AND STEPS TO PROTECT YOUR CREDIT SALES

Scott Blakeley
sblakeley@vendorlaw.com

A record number of bankruptcies for businesses are being reported. Enron filed the largest Chapter 11 ever, with billions in assets and liabilities. Kmart followed, being the largest retailer to file, with assets and liabilities in the billions and 2,100 stores. The notion that a company is simply too large to file Chapter 11, as the company would be rescued by creditors or the government, is gone.

Whether a local business suffering a downturn in business, or public company with a billion dollars in assets, Chapter 11, the reorganization chapter of the Bankruptcy Code, is on the rise. The causes for the spike in Chapter 11 filings are varied. Sept. 11 has been cited by companies as both a direct and indirect factor. Bank financing, bond offerings and IPO's are significantly down, making it difficult for customers to borrow. Commercial insurance premiums are soaring. Revenues for many companies are significantly down, resulting in missed payments to vendors.

A credit professional must pay close attention to existing customers and scrutinize the financial ability of new customers to spot red flags of insolvency. To the credit professional never exposed to an economic downturn, a customer's bankruptcy may seem to appear with little or no warning, especially with the long-term customer that paid within credit terms. What are red flags that a credit professional may identify that a bankruptcy may be in the offing? What steps can a credit executive take to protect open account sales in this environment, more than simply restricting credit or insisting on COD or CIA?

Many Reasons for Filing Chapter 11

A customer may file Chapter 11 for a variety of reasons, such as to stay creditor collection actions, pare down pre-bankruptcy vendor debts, dispose of certain assets, renegotiate or reject leases, and reposition itself in the marketplace.

Insolvency not a Condition to Filing Chapter 11

The credit professional finds that the corporate customer unable to meet its debts seeks refuge with a Chapter 11 filing to stay creditors from collecting on their delinquent accounts. However, the Bankruptcy Code does not require a customer be insolvent to file bankruptcy. Indeed, Chapter 11 has been used by companies to shed burdensome leases, sell assets and deal with mass litigation, such as asbestos claims. The stigma of Chapter 11 seems to have disappeared, and companies that file for Chapter 11 view it as another tool to achieve a business objective.

Where the Debtor Files: The Delaware Train

A credit professional may be surprised to find that a large, local corporate cus-

(continued on page 4)

THE ELECTRONIC CREDIT DEPARTMENT

THE COURTS MAKE IT EASIER TO STAY INFORMED ABOUT PROBLEM CUSTOMERS THROUGH PACER ELECTRONIC DOCKETING IMAGING

Bradley Blakeley
bblakeley@vendorlaw.com

One hallmark of the electronic credit department is the near immediate access to information about a customer by virtue of the Internet. This is also true with the troubled account. Courts throughout the country, both civil and bankruptcy, are announcing the record time of docketing pleadings filed in their cases. These courts also announce that most of the pleadings are imaged often within a day of filing which allows a subscriber to print out documents that detail aspects of a case, such as a Chapter 11 proceeding, or collection lawsuit. This near immediate turnaround time of reporting allows the credit professional updates that allows for a more informed credit decision.

Included is a table of Pacer service web sites.

(Continued on page 10)

CONTENTS

WAS YOUR DEBTOR'S BANKRUPTCY PLANNED? PREVENTING DISCHARGE AND GETTING PAID ON YOUR UNSECURED CLAIM WHEN THE DEBTOR LEAST EXPECTS IT

Richard Ruszat
rruszat@vendorlaw.com

As you may be aware, the Bankruptcy Code presents a unique opportunity for debtors to avail themselves of a "fresh start." Through bankruptcy, debtors are able to discharge or manage burdensome debt and claim limited exemptions for personal and real property.[i] Although payment to creditors is also a goal of the Bankruptcy Code, the fresh start is more often at the expense of unsecured creditors that realize only pennies on the dollar, if a penny at all. In the best of worlds, debtors are candid with disclosures of their finances and assets. In realty, conscientious debtors are seeking ways to maximize their assets and stretch their exemptions with a practice known as "bankruptcy planning."

Maximizing Exemptions versus Defrauding Creditors

Although certain bankruptcy planning practices are acceptable, other practices may prevent the discharge of the debtor's liabilities.[ii] Debtors that possess significant assets risk having their assets collected and liquidated for distribution to creditors. Oftentimes, these debtors will practice bankruptcy planning to protect their assets. Although no clear line of demarcation exists, maximizing exemptions is permissible while a ploy to "hinder, delay or defraud creditors" will prevent discharge. Generally, acceptable bankruptcy planning practices include venue and choice of law decisions, transmutation of a non-exempt asset into an exempt asset, or use of present cash for payments on debt that will not be discharged (e.g., secured debt, taxes, and family support) instead of payment on unsecured lines of credit that are likely to be discharged in bankruptcy. On the other hand, illegal bankruptcy planning practices may include acquiring loans to purchase exempt property, incurring liabilities with an intent to file a bankruptcy petition, and executing transfers of personal or real property to insiders or for inadequate consideration. In any event, it is important to note that courts are variable on acceptable bankruptcy planning practices. Identification of these practices may result in the discovery that the debt is not dischargeable.

Getting a *Handel* on the Estate's Assets

If a debt is not discharged in bankruptcy, then the creditor's claim survives and the creditor may collect against the full value of the debt instead of receiving an insignificant distribution from the estate. *In Re Handel* is an illustrative case of a debtor's egregious effort to use bankruptcy planning practices to conceal a significant portion of assets from creditors.[iii] In *In re Handel*, the bankruptcy court of the Southern District of New York considered a series of challenges to the Debtor's discharge on the Creditor's motion for summary judgment.[iv] Through bankruptcy planning, the Debtor transferred his partnership payments, investment accounts, and retirement assets to his wife, a nondebtor. The

(Continued on page 5)

FROM THE PUBLISHER:

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***Scott Blakeley of Blakeley & Blakeley LLP,
Wells Fargo Tower,
2030 Main Street, Suite 540,
Irvine, CA 92614.
Phone: 949-260-0611 or Fax: 949-260-0613***

or

***Home Savings Bank Tower,
660 South Figueroa Street, Suite 1840,
Los Angeles, CA 90017
Phone: 213-385-5815 or Fax: 213-385-5817.***

***Visit the firm's web site at
www.vendorlaw.com***

THE CASE OF THE DISAPPEARING PROFITS

Paul Beretz

Daniel Dapper, a dynamic salesman with limited financial expertise, founded LIV-HI INC., a CA corp. in 1997. While his profit margins were thin, the business grew to $100,000 monthly sales by the by the latter part of 2001. In December of that year, Mr. Dapper began an expansion program designed to produce an increase of 50% in sales with all expectations of getting his business to a very profitable level.

The program he had outlined gave immediate results. Sales increased dramatically from $100,000 in December to $150,000 by January 2002. As indicated in the very simple summary income statement below (also known as "operating statement" or "profit and loss statement"), the higher revenue generated $15,000 in earnings the first month:

<u>LIV-HI Inc., Income Statement, 1/1/02-1/31/02</u>

Sales	$150,000
Cost of Sales	(105,000)
Gen.& Admin exp.	(30,000)
Net Income	$ 15,000

However, Dan Dapper (known as "Dandy" to his friends) was not in a position to enjoy his success. While the company showed profits, the big jump in sales lead to a $25,000 cash flow deficit. By the end of January 2002, the company was out of cash.

Note:

1. The cash flow deficit was not the result of any unusual event – it developed from the relationships that would impact Dan's cash flow.

2. The deficit was a surprise to the owner (and maybe creditors?). He thought that a profitable operation meant positive cash flow. What is more important - profits or cash flow?

What Mr. Dapper forgot was that the

(Continued on page 6)

POST SEPT. 11: EQUAL CREDIT OPPORTUNITY ACT STILL PROHIBITS DISCRIMINATING AGAINST APPLICANT REQUESTING CREDIT

Scott Blakeley
sblakeley@vendorlaw.com

The terrorist acts of Sept. 11 have unified the country and patriotism has been brought to the forefront. Recent federal legislation, such as the Patriot Act, focuses on ways to combat terrorism, especially from the Middle East. The press has reported racial profiling, for example, where pilots are denying certain passengers to fly. May a credit professional refuse to extend credit to an applicant, say, a sole proprietor originally from the Middle East? The Equal Credit Opportunity Act (ECOA) says no. ECOA is a federal statute that prohibits credit grantors from discriminating in the granting of credit based on prohibited basis, and requires creditors to comply with certain notifications, and retain records. How does ECOA impact a credit professional's commercial credit decision making and notifications, especially post-Sept. 11?

A. What Is ECOA?

ECOA was enacted by Congress in 1989, and the Federal Reserve Board issued Regulation B to implement ECOA in 1990. ECOA is a federal statute that prohibits credit grantors from discriminating in the granting of credit based on a prohibited basis, including race, color, religion, national origin, gender, marital status or age (collectively referred to under the regulations governing ECOA as the "Prohibited Basis"). As ECOA is a federal statute, it applies to all states. ECOA is intended to promote the availability of credit without regard to characteristics that have nothing to do with creditworthiness. Creditors are required to notify applicants of action taken on their applications, and to retain records of credit applications.

ECOA's prohibitions against discrimination are aimed primarily at the evaluation of a credit application by a credit grantor. The general rule is that a credit grantor can consider any information it obtains in evaluating whether to extend credit so long as the information is not used to discriminate against an applicant on a prohibited basis.

1. Only Applies When "Credit" Is Considered To Be Extended

ECOA only applies when "credit" is considered to be extended. "Credit" is defined as "the right granted by a creditor to a debtor to defer payment of a debt or to incur debts and defer its payment or to purchase property or services and defer payment therefore." Thus, a vendor extending business credit on, for example, 30 day terms, can be reasonably read as an extension of "credit" under ECOA.

The regulations promulgated by the Board of Governors of the Federal Reserve System are expansive. Under the regulations, ECOA applies to "credit transactions" which are defined as "every aspect of an applicant's dealings with a creditor regarding an application for credit or an existing extension of credit (including . . . information requirements; investigation procedures; standards of creditworthiness; terms of credit; furnishing of credit information; revocation, alteration, or termination of credit; and collection procedures").

C. Notice Of Credit Decision And Statement Of Reasons: The 30/60/30 Day Rules

ECOA requires credit grantors provide written notification to applicants.

1. Notice of Adverse Action Within 30 Days

Under ECOA, a credit grantor must provide notice to the applicant of action taken with the request for credit within 30 days after a completed application is received by the credit grantor. The possible actions under ECOA are (a) an adverse decision ("Adverse Action"), (b) a counteroffer, or (c) granting the credit requested. Adverse Action is defined as:

> a. Refusal to grant credit in substantially the amount or terms requested - unless the credit grantor makes a counteroffer (for different credit terms) and the applicant accepts the counteroffer;
>
> b. Termination of an account or an unfavorable change in terms; or
>
> c. Refusal to increase the amount of credit available.

(Continued on page 6)

SERVING ON A CREDITORS' COMMITTEE IN YOUR DOT-COM'S E-BANKRUTPCY: THE FIDUCIARY DUTY TO MAXIMIZE VALUE VERSUS PRIVACY INTERESTS

Scott Blakeley
sblakeley@vendorlaw.com

Your dot-com e-tailer customer, which you provide a mid-six figure credit line, files a Chapter 11 e-bankruptcy. You had vigorously attempted to collect the delinquent account, appreciating your salesperson's constant comment that the dot-com would obtain another round of financing from its venture capitalists and pay vendors. However, with the dot-com's e-bankruptcy filing your individual effort to collect the unsecured delinquent account shifts from individual effort to collective effort with other vendors holding the largest unsecured claims.

You are scheduled by the dot-com 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. You complete the form return it to the OUST. The OUST appoints your company to serve on the creditors' committee, and you are designated to serve as the company's representative.

The dot-com's assets are intangible, comprising licensed technology, customer list and engineering team. However, the licensor of the technology refuses to allow the dot-com to continue to use or sell the technology. The dot-com's engineering team is moving on, lured by a competitor's stock options. The good news is that the dot-com has received several offers from competitors proposing to purchase the dot-com's customer list. The customer list now appears to be the only meaningful asset in which to pay vendors. However, the dot-com has provided a privacy pledge to its customers in an effort to attract traffic to its website:

Privacy Guarantee

[W]e take great pride in our relationships with our customers and pledge to maintain

(Continued on page 5)

CHAPTER 11'S ON THE RISE: RED FLAGS AND STEPS TO PROTECT YOUR CREDIT SALES

(continued from page 1)

tomer located, say, in Portland Oregon, files for Chapter 11 in Delaware (or New York).

Major companies often can choose to file for Chapter 11 in a number of jurisdictions, most commonly where they are incorporated, have their headquarters or have major operations. This allows for the company with operations primarily in Oregon, but incorporated in Delaware, to file in that state. Of course, local vendors sense that the Delaware locale is chosen, in part, to make it inconvenient for them to be active in the proceeding. It also allows the company to find a forum more favorable to their interests. In recent years, Delaware's caseload was so heavy that it started imported bankruptcy judges to help out.

Some creditors have objected to the forum shopping, complaining to the bankruptcy judge that Chapter 11 should proceed where the majority of creditors are located. In the Enron Chapter 11's, creditors located in Houston file a motion to have the bankruptcy cases transferred from New York to Houston as the majority of the creditors are located in Houston. The bankruptcy judge in New York handling the cases declined the creditors' request to change venue.

Liquidation Versus Reorganization

As the number of bankruptcies of public companies increase, these companies are increasingly forced to liquidate and sell to the highest bidder instead of reorganize. The reasons companies are being forced to liquidate rather than reorganize includes difficulty in obtaining debtor financing, fewer unencumbered assets and impatient creditors pushing for a bankruptcy sale in hopes of maximizing value and belief that assets are slipping away through continued operations. Liquidations can be in the form of company selling off its assets in a piece meal, as seen with LTV, to companies that sell to the highest bidder as a going concern, such as TWA.

Red Flags Indicating Bankruptcy Looming

Given the spike in bankruptcy filings and uncertain economy, a credit professional's skill to identify red flags that may predict a customer's bankruptcy filing is invaluable. The following warning signs may be of assistance:

Tapped-out with bank. If a customer has drawn down on its bank line of credit, it may not have cash flow to meet its operating obligations. This may also mean that the customer may be not be able to find an alternative source of financing, as it does not have assets to offer as collateral. If the customer is struggling and tapped with its lender it is unlikely to additional funding from the bank or bondholders. With the source of financing stalled, more companies are running out of cash and faced with either shutting their doors, finding a buyer, or securing cash at an extraordinary price.

Bond debt value depreciates. A customer's publicly traded bond debt may be a measurement of impending bankruptcy. Where a customer's bond debt value drops, bondholders are fleeing the investment, perhaps fearing bankruptcy. A customer bond payment that is due may elect to file Chapter 11 rather than make the bond payment.

Stock price decline. When a customer's stock price declines significantly, a number of detrimental consequences result. A customer may find that a collapse of its stock price results in a cut-off of additional financing. Investors are more selective on who they will continue to finance, and are moving their money into investments that are less risky. When stock options are a major employment incentive, management may flee when the stock price drops. The customer may be unable to finance operations as it cannot return to the market for additional financing.

Management and key employee departures. Management, including the CFO, or key employees departs. Their departure may have a significant impact on the customer's continued operations, and thereby jeopardize repayment of a vendor's open account sale.

Post-dating and NSF checks. A customer post-dating checks shows that the customer has insufficient funds to meet vendor obligations, as does the NSF check. This may spur collection of lawsuits.

Withdrawal of vendor credit. While vendors act individually in their decision making for extending credit to a customer, news circulates amongst vendors when key suppliers refuse to continue to provide credit. This may spur the creation of an informal creditors' committee.

Using tax money to pay bills. Should a customer be tapped out of its financing, it may use money earmarked to pay taxing authorities.

Ignoring your e-mails and calls. When a customer begins its financial backslide, the vendor finds its e-mails and phone calls requesting payment are not returned. The customer may also refuse to provide financial information.

Hiring bankruptcy counsel or restructuring consultant. If the customer has retained bankruptcy counsel or investment banker or restructuring consultant, bankruptcy may be next, as the reorganization consultants may encourage an early bankruptcy filing to preserve value.

Personal Relations with Customer may be Key. To protect against unexpected bankruptcies, a credit professional may develop a personal relationship with the customer, which may include customer visits. The personal relationship may provide a better financial picture than the financial information provided. Credit professionals have found that not all financial information is contained on a credit report.

Steps to Protect the Credit Sale When Goods are out the Door

If your goods have been shipped to customer that is insolvent or files bankruptcy, what are your rights?

Stopping Goods in Transit

Under state law, UCC Sections 2-702 (1) and 2-703, if the seller has not yet shipped goods that the buyer ordered on credit terms and the seller discovers that the buyer is insolvent or in bankruptcy, the seller may refuse to deliver the goods to the buyer unless the buyer pays for them. This converts the seller=s payment terms from credit to CBD/CIA or COD. The seller has the same right to withhold delivery of its goods until the buyer pays for them, whether or not the buyer is in bankruptcy.

Reclamation

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The right exists under both state law and the Bankruptcy

(Continued on page 8)

WAS YOUR DEBTOR'S BANKRUPTCY PLANNED? PREVENTING DISCHARGE AND GETTING PAID ON YOUR UNSECURED CLAIM WHEN THE DEBTOR LEAST EXPECTS IT

(Continued from page 2)

Debtor asserted that his actions only constituted transformation of nonexempt assets into exempt assets and that there was no intent to defraud creditors. In addition, an issue arose concerning the value of certain antiques that were listed on an aged financial statement and the Debtor's bankruptcy schedules. Quite remarkably, the financial statement at issue was completed approximately ten years prior to the bankruptcy filing. In its opinion, the bankruptcy court considered the effect of the Debtor's bankruptcy planning on the Debtor's prospect for discharge.

Shuffling Exemptions for a Better *Hand (el)*

Prior to filing the bankruptcy petition, the Debtor transferred his partnership payments, investment accounts, and retirement accounts to his wife. The Debtor denied that these transfers constituted fraud on creditors; rather, the Debtor asserted that the transfers were a means of protecting exempt assets. The Creditor disagreed. Pursuant to § 727 (a)(2)(A), the Creditor moved the bankruptcy court for summary adjudication for a determination that the debt was nondischargeable.[v] This required the Creditor to show that: (1) the transfer occurred one year prior to the bankruptcy petition; (2) the transfer was done with actual intent to hinder, delay, or defraud a creditor or an officer of the estate; (3) the debtor or an agent of the debtor effectuated the transfer; and (4) the transfer concerned the debtor's property.[vi]

The only element at issue was whether the transfer occurred with an actual intent to hinder, delay or defraud a creditor. Since it is unlikely that a debtor will testify to perpetrating a fraud with "actual intent," courts conduct an analysis of the "badges of fraud" to determine whether intent exist.[vii] The badges of fraud include: (1) inadequacy of consideration; (2) transfer of property to family and friends; (3) retention of benefits derived from property; (4) financial condition of the transferring party; (5) transfer of property after incurring debt, financial difficulties, and suits by creditors; (6) omission and misrepresentations on the Debtor's schedules; (7) a debtor's reckless indifference to the truth; and (8) other facts and circumstances evidencing fraud.[viii] The bankruptcy court may deny discharge if any one of the badges exist. Although the Debtor wore several badges of fraud, the bankruptcy court cautiously concluded that a question of fact remained as to whether these particular transfers were done with the "requisite intent to hinder, delay, or defraud the creditor.[ix]

Discrepancy Appears in *Handeling* of the Antiques' Value

The Creditor also moved for summary adjudication to deny discharge on the basis that the Debtor made a false oath on financial statements dating approximately ten years prior to the bankruptcy filing. Pursuant to § 727(a)(4)(A), discharge may be denied if a debtor "knowingly and fraudulently … made a false oath."[x] Under this section, an omission alone from a debtor's statement of affairs or schedules is grounds for denying discharge. At issue were the values assigned to the Debtor's antiques on an aged financial statement and his bankruptcy schedules. The financial statement attested that the value of the antiques was $200,000 whereas the bankruptcy schedules listed the value only at $5,000. To justify the discrepancy, the Debtor claimed that the financial statement was a combination of antiques owned by him and his wife, a majority of which were allegedly purchased by his wife through monetary gifts that constituted separate property. The bankruptcy court concluded that a question of fact remained as to whether the Debtor acted with fraudulent intent. The bankruptcy court also stated that if the Debtor "sincerely" believed that the financial statement requested information about assets belonging to himself and his wife, then the Debtor did not have the requisite fraudulent intent.

The Bankruptcy Court *Handels* It to the Benefit of the Creditor

In its final request for summary adjudication to deny discharge, the Creditor asserted that the Debtor failed to adequately explain the differences in the values assigned to the antique furniture.[xi] Pursuant to § 727(a)(5), discharge may be denied if a debtor fails to explain "satisfactorily … any loss of assets or deficiency of assets to meet

(Continued on page 7)

SERVING ON A CREDITORS' COMMITTEE IN YOUR DOT-COM'S E-BANKRUTPCY: THE FIDUCIARY DUTY TO MAXIMIZE VALUE VERSUS PRIVACY INTERESTS

(Continued from page 3)

your privacy while visiting our site. Personal information voluntarily submitted by visitors to our site, such as name, address, billing information and shopping preferences, is never shared with a third party.

The Federal Trade Commission (FTC) and several state attorney generals object to the proposed sale, claiming the dot-com is breaking its privacy pledge. Do you vote to support the sale of the customer list to a competitor? Does bankruptcy law, or state and federal law, allow a dot-com to avoid performing its obligations under its privacy pledge? If you refuse to support a sale, are you breaching your fiduciary duty to unsecured creditors?

Fiduciary Duties Of Members Of Creditors' Committee And Conflicting Interests Of Privacy Interests With Dot-Com In Bankruptcy

Members of a creditors' committee owe a duty of trust, responsibility and undivided loyalty to unsecured creditors. Consequently, whenever a creditors' committee votes on an issue, the individual members have a strict duty to vote with the overall interests of the unsecured creditors in mind. This interest is to maximize the value of the debtor's assets. A committee member who violates fiduciary duties may be removed from committee, and possibly face personal liability.

Members of a committee have limited immunity in carrying out their duties and powers, but such immunity does not extend to willful misconduct of the committee or its members. The only express grant of immunity to a committee and its members from liability concerns violations of securities laws where a party in "good faith" solicits acceptance or rejection of a plan. Where a committee fails to exercise its duties carefully or a committee makes false or inaccurate statements intending to injure the debtor, members may be subject to suits from the debtor or creditors.

(Continued on page 9)

THE CASE OF THE DISAPPEARING PROFITS

(Continued from page 2)

income statement is an accrual statement – it records sales **when they occur, not 30 days later**, when the business collects the accounts receivable. In addition, expenses are accrued as incurred, although a company may pay those obligations later. Some expenses, such as depreciation and amortization of prepaid items, represent prior cash payments and this even adds more mystery (smoke) to the picture of cash flow – to creditors and the owner.

What Dan Dapper should have recognized in his cash flow is that:

1. A/R, the only source of cash for LIV-HI Inc., may turn (or may not turn) in an average of 30 days.

2. Dan bought $105,000 in inventory in December to meet January's sales forecast and to maintain its credit rating, they had to pay in 30 days.

3. Dan pays all operating expense as incurred, with non-accrued for payment in the following month.

So with these facts in mind, Dan's projected and actual cash flow for January would be:

<u>**LIV-HI Inc., Cash Flow 1/1/01-1/31/01**</u>

Beginning Cash (in bank)
$10,000
Collections (Dec. sales)
100,000
Operating Expenses
(30,000)
Payments (December purchases)
(105,000
Cash shortage
($25,000)

Conclusion: What appears to be a $15,000 profit for the month of January is a $25,000 cash flow deficit. The $40,000 difference emphasizes the difference between accrual and cash accounting.

Solving the Mystery: Dan Dapper could have filled the funds gap with external financing, additional investment or accelerating collections of accounts receivable.

(Continued on page 7)

POST SEPT. 11: EQUAL CREDIT OPPORTUNITY ACT STILL PROHIBITS DISCRIMINATING AGAINST APPLICANT REQUESTING CREDIT

(Continued from page 3)

If Adverse Action is taken, notice must be provided by the credit grantor to the applicant that the party has the right to request reasons for the Adverse Action in writing within 60 days of such action. *See* Attachment A. Notification may be done verbally if the application was verbally made, otherwise it must be done in writing. ECOA provides that the notice of Adverse Action must contain language advising of ECOA similar to that in Attachment A.

2. Credit Applicant's Request For Statement Of Reasons Within 60 Days

The applicant has 60 days from receipt of the credit grantor's Adverse Action letter to request an explanation of adverse ruling.

3. Credit Grantor's Statement Of Reasons Within 30 Days

If an applicant requests an explanation of Adverse Action within 60 days, the credit grantor is to provide a statement of reasons within 30 days. The credit executive is not required to provide specific reasons for the Adverse Action, but instead may provide language such as, "adverse credit history"; "lack of business experience"; "lack of working capital"; or "too much secured debt." One form of letter addressing the statement of reasons letter is provided as Attachment C.

C. Obtaining A Spouse's Guarantee

ECOA does not permit a credit grantor to require a spouse to sign a personal guaranty if that spouse is not directly involved with the applicant. A personal guarantee can be required only when an applicant does not meet the creditor grantor's scoring model for credit. If the business owner's spouse is not involved in the business and does not hold a position with the corporation, a personal guarantee that includes the spouse may be discriminatory.

D. Retention Of Records

ECOA requires credit grantors to retain records for applicants denied credit. The records a credit grantor retains are the credit application, the credit grantor's notification of action, the statement of specific reasons for the adverse action and the applicant's written statement alleging violation of ECOA.

The period of time that the records must be retained depends on the amount of the gross revenues of the applicant. For credit applicants with gross revenues of $1 million or less, the credit professional must keep records for 12 months after notification. For credit applicants with gross revenues in excess of $1 million, the credit professional must keep records for at least 60 days after notification. However, if an applicant requests that the records be retained, the creditor must retain the records for 12 months.

Retention of records is required beyond 12 months if the credit grantor has notice that it is under investigation, is subject to an enforcement proceeding, or is served with notice of an action filed. Then records must be kept until the later of the 12 months or the final disposition of the matter, unless an earlier time is allowed by court order.

The statute of limitations to commence an action against the credit grantor is two years after applying for credit.

E. ECOA In The Internet Age

The Internet is revolutionizing how the credit professional handles credit transactions. Credit professionals are using the Internet for a myriad of credit and financial functions, from credit research and scoring, to automatic invoicing customers through their Web site, to automatic payment posting. Credit departments are loading their web pages with credit applications and guarantees for the customer to retrieve. The electronic credit department has arrived.

The Electronic Signatures in Global and National Commerce Act (The E-Sign Act) makes e-signatures as legally binding as ink-and-paper signatures. The E-Sign Act also eliminates legal barriers to storing documents and sending notices electronically. A credit professional may now

(Continued on page 8)

WAS YOUR DEBTOR'S BANKRUPTCY PLANNED? PREVENTING DISCHARGE AND GETTING PAID ON YOUR UNSECURED CLAIM WHEN THE DEBTOR LEAST EXPECTS IT

(Continued from page 5)

the debtor's liabilities."[xii] Unlike the other sections, § 727(a)(5) does not require an intent analysis and is construed broadly. If a creditor establishes that a loss occurred, the burden shifts to the debtor to explain that any conduct was the product of good faith and business-like conduct. Furthermore, vague and indefinite explanations of losses are deemed unsatisfactory if based on estimates and uncorroborated by documentation. The bankruptcy court concluded that the Debtor's "self-serving" statements regarding ownership and value of the antiques were unavailing and not corroborated with any documentation. Accordingly, the bankruptcy court entered summary judgment for the Creditor and denied the Debtor's discharge.

Conclusions

In re Handel is an illustrative case of the effect of bankruptcy planning on a debtor's discharge. It also presents a valid avenue for creditors to challenge discharge if the creditor can research the debtor's prior financial dealings. Although the courts may consider certain practices as legitimate (e.g., transformation of non-exempt assets to exempt assets), other practices are clearly suspect and may be grounds to deny discharge (e.g., value discrepancies and transfers to insiders). The bankruptcy court is clear that the intent requirement under certain provisions of § 727 is the central focus of the inquiry. If intent can be inferred from the facts and circumstances of a particular case, then a creditor may be able to successfully challenge a debtor's discharge. The creditor need not establish actual intent. Moreover, § 727(a)(5) does not require any showing of intent if there is a discrepancy in the value of assets listed on financial documents, or any other document, and the debtor's bankruptcy schedules. If a discrepancy is found, a debtor is required to satisfactorily explain the disappearance of assets prior to the bankruptcy filing. If the debtor fails to satisfactorily explain the demise in assets, then discharge may be denied and the creditor may seek recovery from the debtor for the full amount of its claim.

i. The Bankruptcy Code gives each state an option with regard to exempt property that is protected from creditors. Pursuant to the Bankruptcy Code §§ 522 and 541, a state may allow debtors to: (1) exempt from their bankruptcy estates property included in the federal "laundry list" of exemptions, or (2) rely on state law and federal law other than the laundry list for allowable exemptions. *See* 11 U.S.C. §§ 522 and 541. Additionally, a state may also entirely "opt out" of the federal exemption scheme. *See* 11 U.S. C. § 522(b)(1).

The option scheme has provided for varied results among the states. For example, pursuant to federal law, the exemption value for a homestead is $15,750.00. However, the State of Florida, subject to very limited exceptions, provides an exemption for the full value of the homestead. *See* Fla. Const. art. X § 4 (West 2002); *See also* Fla. Stat. § 222.01 (West 2002). Additionally, states may add exemptions for personal property that are not listed under the Bankruptcy Code. A unique exemption is found under Texas law, which permits an exemption for two (2) firearms (certainly, this adds to smooth relations among aggressive creditors). *See* Tex. Prop. Code. Ann. § 42.002(a)(7)(West 2002). As one Texas bankruptcy court noted, "the typical hunter serious about his or her sport will have a shotgun for birds and a rifle for other game." *See In re Schwarzbach*, 1989 WL 360742, *4 (W.D. Tex.1989).

ii. A majority of consumer debtors willpossess assets that meet the exemption requirement under state and federal law, and therefore, these assets are out of the reach of creditors.

iii. *See In re Handel*, 266 B.R. 585 (Bankr. S.D.N.Y.2001).

iv. The Debtor also filed a cross-motion for summary adjudication, which the bankruptcy court denied on all claims. The bankruptcy court did not discuss the reasoning for its denial of the cross-motion for summary judgment.

v. *See* 11 U.S.C. § 727(a)(2)(A).

vi. *See Id.*

vii. *See Najar v. Kablauoui (In re Kablaouli), 196 B.R. 705, 709* (Bankr.S.D.N.Y.1996).

viii. *See Salomon v. Kaiser (In re Kaiser),* 722 F.2d 1574, 1582-83 (2nd Cir. 1983).

ix. The Creditor also moved for summary adjudication pursuant to § 727(a)(2)(B) for transferring unnamed assets from his estate to his wife's account. Section 727(a)(2)(B) permits the bankruptcy court to deny discharge if the debtor, with an intent to "hinder, delay, or defraud a creditor … transfers property from the estate, after the date of filing the petition." *See* 11 U.S.C. § 727(a)(2)(B). The bankruptcy court concluded that the same analysis under § 727 (a)(2)(A) applied and denied summary judgment to determine whether the transfers were to protect exempt assets or to defraud creditors. *See In re Handel*, 266 B.R. at 589.

x. *See* 11 U.S.C. § 727(a)(4).

xi. The Creditor also moved for summary adjudication on the basis that the Debtor failed to adequately explain the reasons that his capital account at his law firm had a positive value of $400,000 in 1989, whereas it had a negative value at the time the bankruptcy petition was filed. *See In re Handel*, 266 B.R. at 590. The Debtor attributed the negative balance to a change in accounting methods and the loss of a valuable asset at the firm. *See Id* at 591. Although the bankruptcy court denied summary judgment on this issue, it did not state its reasoning. The logical inference is that the bankruptcy court believed that this explanation was satisfactory.

xii. *See* 11 U.S.C. § 727(a)(5).

THE CASE OF THE DISAPPEARING PROFITS

(Continued from page 6)

What is the Moral of the Story?

Credit managers beware: look for the "hidden card," the smoke, the mirrors: watch the flow of cash!

[1] Paul Beretz, CICE(Certified International Credit Executive), is the founder and Managing Director of Pacific Business Solutions, a consulting company which specializes in providing strategic planning and cash flow solutions. Paul received his BBA from the University of Notre Dame, an MBA from Golden Gate University and the Executive Award from the Graduate School of Credit and Financial Management at Stanford University. His e-mail is pberetz@pacbizsolutions.com.

CHAPTER 11'S ON THE RISE: RED FLAGS AND STEPS TO PROTECT YOUR CREDIT SALES

(Continued from page 4)

Code. Under the Bankruptcy Code, a court generally does not allow a vendor to reclaim the goods. Rather, a vendor is given a priority claim for the value of the goods. The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor 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 where the buyer does not misrepresent solvency.

Essential Vendor Program

On occasion a vendor may find that the product or service it provides a Chapter 11 debtor is essential and is key to the debtor's continued operations. The uniqueness of the product or service may give such a vendor leverage in negotiating post-bankruptcy sales. In this situation, the debtor may request the bankruptcy court allow it immediately to pay the vendor's prepetition claim, in exchange for the vendor committing to sell on credit to the Debtor post-bankruptcy. The Doctrine of Necessity says that the debtor needs the vendor's product or service in order to reorganize its finances.

Steps to Reduce Credit Risk

Given the dramatic rise in bankruptcy filings and uncertain economic environment, the credit professional may consider alternatives to reduce credit risk, yet still make the sale. Those alternatives may include, a secured sale, either with a purchase money security interest or a security interest in all of the customer's assets, which is junior to the preexisting lender. The vendor may insist on a consignment sale, wherein title to the vendor's goods does not pass to the customer until sale of the goods. The vendor may also consider insisting on the customer providing either a corporate guarantee or a personal guarantee from the customer's principals. A letter of credit may also be considered to reduce risk. The vendor can obtain a standby L/C, which assures payment by a third party after the customer's default.

Commercial credit risk and customer defaults have increased significantly. The credit professional, especially one not experienced with an economic downturn, must be especially vigilant in identifying red flags that may signal a customer's bankruptcy or failure to pay the open account sale. Perhaps these steps will help the credit professional reduce risk of loss.

POST SEPT. 11: EQUAL CREDIT OPPORTUNITY ACT STILL PROHIBITS DISCRIMINATING AGAINST APPLICANT REQUESTING CREDIT

(Continued from page 6)

engage in e-credit transactions across state lines and the credit sale contract is valid in all states.

Neither the E-Sign Act nor the ECOA should bar a credit professional from electronically notifying an applicant of Adverse Action or storing credit information electronically, and otherwise be in full compliance with the FCRA. However, the E-Sign Act requires that the consumer decides whether to use an e-signature or handwritten signature, and the vendor must conduct test e-mailings before sending out subsequent e-mail notifications.

1. E-Notification Of Adverse Action And Statement Of Reasons

ECOA requires a credit grantor give notification of Adverse Action. The E-Sign Act may allow a credit grantor to give electronic notification of Adverse Action and statement of reasons.

2. Storing Credit Applications Electronically

The E-Sign Act authorizes storing documents electronically. This means that a credit professional may store electronically the credit files of declined applicants.

F. Avoiding The ECOA Lawsuit: Steps To Comply

A paper trail demonstrating to disgruntled applicants (or their counsel) or FTC audits that a credit grantor complies with ECOA can be useful in keeping lawsuits at bay. To comply with ECOA, there are several steps a credit grantor may consider adopting. These steps assist the credit grantor in creating a paper trail evidencing compliance with ECOA.

1. **Company Policy:** consider adopting a stated policy that there shall be no discrimination on a prohibited basis with the extension of credit.
2. **Written Manual:** consider including in your company's policy manual a statement the company complies with ECOA.
3. **Training The Troops:** Train credit and sales personnel about ECOA. ECOA may also apply to the credit grantor's sales' brokers and agents if the company cloaks them with authority to request credit information from the applicant.
4. **Credit Application**: The credit application should provide for statement of the vendor's compliance with ECOA. *See* Attachment A. The credit application should not include any language or seek information that may lead an applicant to believe that the information sought would be used to discriminate. *See* Attachment A.
5. **Personal Guarantee:** ECOA does not permit a credit grantor to require a spouse to sign a personal guaranty if that spouse is not directly involved with the applicant.
6. **Notification To Applicant:** Comply with the 30/60/30 written notification.
7. **Record Keeping:** Store credit records. Digital records may be recognized.

G. Types Of Evidence Proving Credit Discrimination

What type of evidence may prove a violation of ECOA?

1. Overt Discrimination: When a credit grantor blatantly discriminates on a prohibited basis. Expressions of a discriminatory preference may constitute a violation of ECOA even if the credit grantor does not act on the preference. The example post Sept. 11 where a credit professional refuses to sell a sole proprietor of Middle Eastern origin because of his origin.

2. Disparate Treatment: When a credit grantor treats applicants differently based on a prohibited basis. May

(Continued on page 9)

POST SEPT. 11: EQUAL CREDIT OPPORTUNITY ACT STILL PROHIBITS DISCRIMINATING AGAINST APPLICANT REQUESTING CREDIT

(Continued from page 8)

be overt or subtle and does not require evidence that differences in treatment were caused by prejudice or conscious intention to discriminate.

3. Disparate Impact: When a credit grantor applies a policy or practice uniformly to all applicants, but the policy or practice has a disproportionate effect on groups protected under ECOA. No violation of ECOA if the disparity created by the policy or practice is justified by business necessity and there is no less discriminatory alternative.

I. Enforcement Of ECOA

Enforcement of ECOA may be through private lawsuit or through administrative enforcement. A creditor failing to comply with ECOA may be subject to civil liability for actual and punitive damages in either individual or class action lawsuits. Punitive damages are capped at $10,000 in individual lawsuits; and capped at the lesser of $500,000 or 1% of the creditor's net worth in class action lawsuits. Winning plaintiffs may also recover from the defendant reasonable attorneys' fees and costs. The Federal Trade Commission regulates ECOA.

J. Post Sept. 11, The Credit Professional Cannot Discriminate With Credit Decision

Post Sept. 11 has caused us to consider those around us in different a light, given the continued threat of domestic terrorism. The country has come together on a united and patriotic way. On the commercial credit front, post Sept. 11 neither the U. S. Congress nor the FTC have changed ECOA's prohibition of denying credit based on national origin or race, for example, where a sole proprietor from the Middle East requests commercial credit.

SERVING ON A CREDITORS' COMMITTEE IN YOUR DOT-COM'S E-BANKRUTPCY: THE FIDUCIARY DUTY TO MAXIMIZE VALUE VERSUS PRIVACY INTERESTS

(Continued from page 5)

Committee's Duty To Maximize Value v. Privacy Rights

A dot-com's customer list may be valuable to its competitors as the customer list contains information concerning a customer's buying preferences, names and ages of children, credit card numbers, birth dates, and other information, which customers may not wish to disclose to third parties. For years, brick-and-mortar companies have sold their customer lists as assets in bankruptcy proceedings without objections by government agencies. However, due to the detailed nature of the customer list and the dot-com's privacy pledge, its treatment in an e-bankruptcy may bring conflicting interests with creditors.

There is no federal law that prohibits a dot-com to sell its customer list. However, a dot-com may encounter opposition in trying to sell its customer list, where privacy was promised by the dot-com when the customer information was collected.

The dot-com Toysmart.com generated controversy with its attempts to sell its customer list. Unable to pay its creditors, Toysmart filed Chapter 11. Toysmart solicited bids for its assets, which included its customer list, despite a posted privacy statement promising not to share such information. Toysmart's customer list comprised 250,000 customer names and related information, including addresses, shopping preferences, order history, billing information, credit card numbers, family profile, including information about customers' children. Toysmart believed the customer list was worth millions of dollars. Toysmart pledged to its customers that information provided would be private.

Toysmart had its web site's privacy policy certified by the TRUSTe Privacy Seal Program. Under the privacy seal program, a customer can protect information by clicking on the seal.

Using its police powers, the FTC sued Toysmart for deceptive trade practice, alleging that in attempting to sell its customer list, Toysmart was breaking its own posted privacy policy and violated fair trade practices, and that the bankruptcy court should stop any sale of the customer list. 38 state attorney generals filed objections with the bankruptcy court also seeking to bar the sale of the list.

The FTC reached a settlement with Toysmart that allowed the company to sell its customer list, but only if the bidder complied with the same privacy policy. The creditors' committee of Toysmart objected to the settlement between Toysmart and the FTC, complaining that the settlement would chill bidding. The bankruptcy court refused to accept the deal, instead waiting to see if bidders surfaced. No company bid for the customer list. Toysmart was paid $50,000 by Disney to have its customer database destroyed rather than being sold off to pay creditors.

The Toysmart customer list dispute highlights the conflict of interest between privacy concerns on the one hand and creditors' committee interests on the other. The creditors' committee's duty is to maximize the value of assets. A customer list is often one of the few assets of an insolvent dot-com that may be sold in an e-bankruptcy.

However, privacy rights and the Internet are of significant concern for the U. S. Congress, state legislatures and state and federal regulatory agencies. The U.S. Congress is expected to pass federal legislation to protect a consumer's privacy rights on the Internet. Independent of federal legislation, states have stepped-up their interest in pursuing their own claims under state consumer protection laws. Several states have proposed laws concerning online privacy. Federal and state regulatory agencies do not believe that the Bankruptcy Code preempts their police powers to enjoin a dot-com from selling its customer list where it has made a privacy pledge.

In an attempt to avoid Toysmart's problems of blocking
the sale of a customer list, some dot-com e-tailers have changed their privacy statement. Amazon now discloses:

In the unlikely event that Amazon.com, or substantially all of its assets are acquired,customer information will, or course, be one of the transferred assets.

(Continued on page 10)

THE COURTS MAKE IT EASIER TO STAY INFORMED ABOUT PROBLEM CUSTOMERS THROUGH PACER ELECTRONIC DOCKETING IMAGING

(Continued from page 1)

PACER SERVICE CENTER

National Index

U.S. Party/Case Index	Pacer.uspci.uscourts.gov

U.S. Courts of Appeals

First Circuit	Pacer.cal.uscourts.gov
Fourth Circuit	Pacer.ca4.uscourts.gov
Sixth circuit	Pacer.ca6.uscourts.gov
Eighth Circuit	Pacer.ca8.uscourts.gov
Ninth Circuit	Pacer.ca9.uscourts.gov
D.C. Circuit	Pacer.cadc.uscourts.gov

U.S. Bankruptcy Courts

Alaska	Pacer.akb.uscourts.gov
Arkansas, Eastern & Western Districts	Pacer.areb.uscourts.gov
California, Northern District	Pacer.canb.uscourts.gov
California, Southern District	Pacer.casb.uscourts.gov
Colorado	Pacer.cob.uscourts.gov
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New York, Western District	Pacer.nywb.uscourts.gov
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North Carolina, Middle District	Pacer.ncmb.uscourts.gov
North Dakota	Pacer.ndb.uscourts.gov
North Dakota-RACER	Racer.ndb.uscourts.gov
Ohio, Southern District	Pacer.ohsb.uscourts.gov
Oklahoma, Eastern District	Pacer.okeb.uscourts.gov
Oklahoma, Eastern District-RACER	Racer.okeb.uscourts.gov
Oregon	Pacer.orb.uscourts.gov
Pennsylvania, Eastern District	Pacer.paeb.uscourts.gov
Pennsylvania, Western District	Pacer.pawb.uscourts.gov
South Carolina	Pacer.scb.uscourts.gov
South Dakota	Pacer.sdb.uscourts.gov
Tennessee, Eastern District	Pacer.tneb.uscourts.gov
Tennessee, Western District	Pacer.tnwb.uscourts.gov

(Continued on page 11)

SERVING ON A CREDITORS' COMMITTEE IN YOUR DOT-COM'S E-BANKRUTPCY: THE FIDUCIARY DUTY TO MAXIMIZE VALUE VERSUS PRIVACY INTERESTS

(Continued from page 9)

The new disclosure may allow a dot-com to sell its customer list should it fall into insolvency, given that the FTC and attorney generals' claims were based on Toysmart's alleged misrepresentations to its customers.

However, if the dot-com e-tailer has made a privacy pledge to its customers like in Toysmart, and attempts to sell its customer list through bankruptcy, the FTC and state and attorney general will likely attempt to bar the sale. Given courts consistent rulings that a creditors' committee duty is to maximize the value of a debtor's assets, and given that there is no state or federal law that bars a dot-com from selling its customer list, a creditors' committee support of a dot-com's attempts to sell its customer list should not open the door for some derivative claim by the FTC or attorney general against the committee. Indeed, given that a customer list may be the only asset of a dot-com that may generate a meaningful return for creditors, should the creditors' committee not support a sale of the customer list, this may open the door for claims by unsecured creditors against the committee and its members for failing to uphold their duty to maximize the value of assets. One alternative for the committee facing this sticky issue may to get creditors' committee insurance.

THE COURTS MAKE IT EASIER TO STAY INFORMED ABOUT PROBLEM CUSTOMERS THROUGH PACER ELECTRONIC DOCKETING IMAGING

(Continued from page 10)

U.S. Bankruptcy Courts (continued)

Texas, Eastern District	Pacer.txeb.uscourts.gov
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RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Spring 2002

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

- ◊ Scott Blakeley spoke to the **National Distribution Group** in **Phoenix** regarding **Escheatment and Creditors' Rights.**
- ◊ Scott spoke at **NACM/Chicago-Midwest** in **Chicago** regarding **The Credit Department in a Time of War and Terrorism: Dealing with the Aftermath of September 11.**
- ◊ Scott spoke to the **Export Development Company** in **Ottawa, Canada** regarding **Bankruptcy and Creditors' Rights.**
- ◊ Scott spoke at the **NACM Loss Prevention Department** in **Las Vegas** regarding **Internet and the Credit Professional and Your Customer's Privacy Rights.**
- ◊ Scott spoke to the **National Building Industry Group** in **Phoenix** regarding **Credit Enhancements.**
- ◊ Scott spoke at **NACM/Portland** in **Portland, Oregon** regarding the **The Corporate Meltdown of Enron and 2002: A New Millennium of Laws, Regulations and Court Decisions for the Credit Professional.**
- ◊ Scott spoke to **Reimer Reporting's National Cable Industry Group** regarding **The Top Ten Bankruptcy Topics Affecting the Credit Professional** and **Who is Responsible for Payment to a Media Company for Advertising?**
- ◊ Scott spoke to **CMA Business Credit's Computer Industry Group** regarding **The Credit Department Post Sept. 11.**
- ◊ Scott spoke to the **National Snack Food Group** in **New Orleans** regarding **Beating the Bankruptcy Preference** and **The Credit Department Post Sept. 11.**
- ◊ Scott spoke to the **International Credit Executives** in **Milwaukee** regarding **The Internet and International Credit Issues.**
- ◊ Scott and Richard Ruszat are contributing editors to **NACM's 93rd Edition of Manual of Credit and Commercial Laws.**
- ◊ Scott contributed to **IOMA's Essentials of Credit, Collections and Accounts Receivable.**

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Wells Fargo Tower
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