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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

CRITICAL VENDOR UPDATE: MAKING THE CRITICAL VENDOR LIST AND THE TRADE CLAIMS CAP

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The credit professional well knows that a customer's Chapter 11 means long delays before receiving any payment on the prepetition account, which payment is usually but a fraction of the claim. Indeed, it is not uncommon for the vendor to receive stock in the reorganized debtor in exchange for its prepetition claim. Traditionally, the vendor would file a proof of claim, perhaps serve on the creditors' committee, and press for a meaningful payment. Does a vendor in this situation, especially one with substantial trade relationship, have any recourse? Fortunately, with the development of the critical vendor doctrine, the credit professional may have a meaningful alternative.

On occasion a vendor may be a key supplier to a customer which files Chapter 11. Given this key supplier relationship, the vendor often holds a sizeable unsecured claim upon the Chapter 11 filing. The vendor, selling invoice by invoice (as opposed to long term supply contract), may elect not to continue to sell the debtor postpetiton. However, the vendor's product or service may be viewed by the debtor as essential to its continued operations.

In this situation the debtor may request that the court authorize it to immediately pay the vendor's prepetition claim, in exchange for the vendor selling to the debtor post-bankruptcy on credit. Under the critical vendor doctrine, a vendor may find that the product or service it provides a Chapter 11 debtor is essential to continued operations. The uniqueness of the product or service may give the vendor leverage in negotiating post-bankruptcy sales.

More and more bankruptcy courts are considering a debtor's request to treat certain vendors as critical and have their pre-bankruptcy claims paid in exchange for postpetition trade credit. As a bankruptcy court noted, "[p]ayment of the prepetition claims of these vendors as set out in the Debtor's motion is necessary to realize the possibility of a successful reorganization. . . the Court may authorize the payment of prepetition claims when such payments are necessary to the continued operations of the Debtor." *In re Wehrenberg, 260 B.R. 468 (Bankr. MO 2001).*

The Critical Vendor Doctrine

To be classed as "critical" by a Chapter 11 customer is usually an extraordinary result for the vendor as it means payment in full or a substantial portion or the prepetition claim, given the alternative of waiting, perhaps for years but for a fraction of the prepetition claim. However, a Chapter 11 debtor's funds available for the critical vendor class is limited, as well as scrutinized (and perhaps objected to) by lenders, bondholders, noteholders, a creditors' committee, the U.S. Trustee's office, and even competing vendors who want to be elevated

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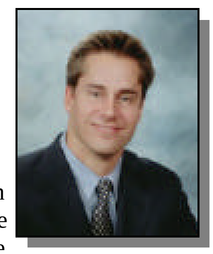

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You sell your product on unsecured credit to a sole proprietor business. The customer uses the proceeds from the sale of product you provided to pay other creditors. You go unpaid. The customer files personal bankruptcy and schedules your claim as unsecured, to be discharged through the bankruptcy. By virtue of the customer using the proceeds from the sale of your product, do you have a basis to have your claim deemed nondischargable? How do the nondischargability provisions of the Bankruptcy Code work, and in what instances may a vendor use these laws to have the claim survive the bankruptcy, allowing the vendor to pursue payment in the future? A bankruptcy court, *In re Wright*, recently considered the issue and found the vendor's debt could be discharged.

Debtor Pays Other Creditors with Proceeds from Vendor's Product

In *Wright*, the vendor sold seed on credit to the debtor, a sole proprietor.

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THE USA PATRIOT ACT: A PRIMER TO COMPLIANCE REQUIREMENTS

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On October 26, 2001, Congress passed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (the "USA PATRIOT Act"). Although the main purpose of the USA PATRIOT Act is to bolster national security, its practical implications are widespread to financial and non-financial institutions. The USA PATRIOT Act promulgates broad, new requirements for both financial institutions and non-financial institutions. Under the USA PATRIOT Act, a non-financial institution is required to report cash and currency transactions. On the other hand, a financial institution, whether domestic or foreign, includes banks, brokers, futures merchants and commodities traders, investment bankers, and insurance companies. Surprisingly, financial institutions also include entities that are not usually associated with traditional financial institutions such as *casinos, and real estate brokers, pawnbrokers, travel agencies, jewelers, and automobile and boat retailers.*

Non-Financial Institutions

Non-financial institutions are required to report cash and currency transactions totaling $10,000, or more ("Cash Transactions") to the Financial Crimes Enforcement Network ("FinCEN"). Cash Transactions include monetary instruments such as travelers' checks and other negotiable instruments.

Financial Institutions

The primary provision affecting financial institutions is Title III of the USA PATRIOT Act, entitled "International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001" ("Title III"). Title III requires an institution to take reasonable steps to safeguard against money-laundering. The primary safeguard measures include: (1) designating a compliance offer; (2) implementing an ongoing training program; (3) adopting an independent audit function; and (4) developing internal policies, procedures, and controls. There are no specific guidelines or procedures to direct compliance; instead, an institution must determine its own particular risks in developing a program, which is likely to include an analysis of its customer base, industry, and location. As in the context of traditional financial institutions, compliance is more a matter of fine tuning and reassessment since anti-money laundering programs are already in place; however, for untraditional financial institutions, a category which is growing, implementing a compliance program will present significant adjustment to operations.

In addition to implementing a compliance program, financial institutions

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FROM THE PUBLISHER:

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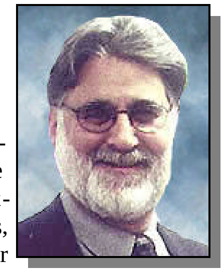

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Your company is experiencing an increase in Days Sales Outstanding. Customers, who have paid at, or near terms, are now paying slow. Customer deductions and disputes are increasing. The perception is the credit and collection department is the primary place to look to get cash flow back on track. This scenario sounds all too familiar to many credit and financial professionals today.

The traditional reaction is to review credit policies and tighten where possible. The Credit Department must do what is necessary to reduce risk of slow payment and potential bad debts. The collection process and supporting staff are scrutinized in an effort to find where the ball is being dropped and what corrective actions are necessary.

All this makes perfect sense, but in today's business environment, these steps focus only on part of the picture. It is critical to go upstream in the quote to cash process. There is a chain of interrelated steps that drive what ultimately becomes an open item on the Aged Trial Balance. This goes far beyond the walls of the credit and collections department. The effort must involve all areas of the business. Pricing and terms policies, product quality, administration of product delivery and return, order entry, billing and cash application all impact a company's ability to manage incoming cash flow.

The "holistic" approach integrates the entire "revenue chain" and involves all parts of the organization. This requires a review of interrelated processes, organizational structure and supporting systems and automation. Results will be collection performance improvement, better management of credit risk, a more efficient and productive operation as well as reductions in overhead costs, administrative errors and invoice discrepancies.

Following are ideas as to how to effectively approach this issue by coordinating other areas within the company. Actions can be taken to improve collection performance at each step of the quote to cash process.

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DEFENDING A PREFERENCE CLAIM UNDER THE SOLVENCY DEFENSE: WHAT THE VENDOR MUST PROVE

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Your customer files Chapter 11. Two years later, you receive a demand letter from the litigation trustee demanding return of payments within the 90 days of the customer's filing. You consider the common preference defenses, contemporaneous exchange, ordinary course of business and new value. You review the debtor's most recent audited financial statements which covered a portion of the preference period. The public financial statements show the debtor was apparently solvent during this period. You consider the preference defense of solvency, which provides that if the debtor was solvent at the time of preferential transfer the vendor may have an absolute defense. How may a court consider this defense? How are the debtor's assets and liabilities valued during the preference period? What evidence must the vendor introduce to prevail on this defense?

In the bankruptcy case of Payless Cashways, the bankruptcy court recently ruled that the debtor, who had filed a second chapter 11, was solvent during the preference period and thus payments to vendors during the preference period could not be recaptured. In *In re Lids Corporation*, 281 *B.R. 535 (Bankr. D. Del. 2002)* the bankruptcy court considering the solvency defense ruled otherwise. The *In re Lids* decision is considered.

Insolvency Dispute

In *Lids*, a retailer of licensed logo sports caps, filed chapter 11. The debtor lost money the three years prior to bankruptcy. Prepetition, the debtor executed a secured credit agreement with a lender. The debtor also granted a junior security interest in its assets to a creditor when it defaulted on its financing with its lender. The creditor perfected its security interest during the preference period.

The debtor filed a preference complaint to avoid the security interest against the creditor, thereby attempting to lower the creditor's payment standing to unsecured. The creditor's defense to the preference was that the debtor was solvent at the time it took a security interest in the debtor's assets.

The Avoidance Powers

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 Uniform Commercial Code, 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, if the recordation of the lien -- for example, filing of a UCC-1 with the appropriate filing office when the collateral is the debtor's personal property -- is untimely.

Presumption of Insolvency During Preference Period

While a business that is filing Chapter 11 usually does so because its liabilities exceed assets, the Bankruptcy

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DEBTOR IN POSSESSION FINANCING IN THE SPOTLIGHT: DOES DIP LENDER GUARANTEE PAYMENT OF YOUR POSTPETITION CREDIT SALE?

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"Debtor in possession financing" is a phrase frequently heard by the credit professional these days with a customer filing Chapter 11. A corporate customer who seemingly has run out of cash to pay its debts and finance operations, suddenly announces that it has arranged a new credit line with its lender by virtue of filing Chapter 11—the so-called DIP financing or DIP facility. Lenders prefer to finance existing customers in financial difficulty using a DIP facility as it puts them in first position at assets, allows greater control over the company and provides higher interest rates and fees.

Key vendors to the customer filing Chapter 11 are often approached by the customer requesting credit sales postpetition. The customer often exclaims there is no credit risk for the vendor as it now has a DIP facility to pay vendors' postpetition credit sales. But is there risk for the vendor with the postpetition credit sale, even with DIP financing in place? What happens where the vendor sells on credit postpetition, the DIP lender refuses to continue financing and the vendor goes unpaid. Does the DIP lender, in effect, guarantee the vendor payment on its credit sale?

The bankruptcy court in *In re Forman Industries, Inc.*, 280 B.R. 609 (WD Penn. 2002), ruled that a DIP lender was not liable to vendor where postpetition credit sale went unpaid.

In *Forman Industries*, the debtor encountered financial difficulties and was forced to file Chapter 11 to orderly liquidate its assets. It obtained DIP financing that permitted it to purchase goods in the ordinary course of business. The DIP lender had a lien covering all of the debtor's assets, including inventory shipped to the debtor postpetition on credit.

A vendor sold custom-ordered goods on credit postpetition for the debtor's going-out-of-business sales and received a

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to critical vendor status.

With some of the largest public companies filing Chapter 11, critical vendor motions are more common -— and more scrutinized than ever. Bankruptcy judges are now often insisting on detailed support to pay a vendor immediately on the prepetition claim. The judges are also granting immediate relief on an interim basis in order to give other parties involved, such as a creditor's committee, time to review the request.

The critical vendor doctrine may be viewed as conflicting with a fundamental principle of bankruptcy which is equal treatment (e.g. payment) for the same class of unsecured creditors' claims. In bankruptcy, the general rule is that vendors may be paid on their unsecured claims only through a confirmed plan of reorganization or court-authorized liquidation.

A number of courts throughout the country have carved an exception to this general rule and labeled it the critical vendor doctrine. Under the doctrine, a debtor may pay certain prepetition claims, with court approval, at the commencement of the bankruptcy case where it can be established that payment of those claims will help to stabilize the debtor's business without significantly harming any party. The payment of these claims is to induce vendors to continue supplying key goods and services post-bankruptcy on credit, which may enable a debtor to continue to operate and perhaps exit bankruptcy. In exchange for the vendor being paid in full, the debtor conditions the vendor extending comparable credit terms postpetition. The critical vendor agreement is reflected in a letter agreement between the debtor and the vendor. The agreement also provides for a "claw back" provision that permits the debtor to recapture the critical vendor payment if the vendor refuses to continue to extend credit.

A number of bankruptcy courts, from United Airlines to Encompass, have recently approved the debtor's request for a critical vendor program, subject to a claims' cap. How does the vendor get on the critical vendor list? What is a claims cap?

Making the Critical Vendor List

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment. The debtor places the "critical" vendors on a list. Those vendors that do not make the list will receive payment through a confirmed plan of reorganization or Chapter 7 liquidation, often years after the filing. The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment on the prepetition claim. The motion also binds the vendor to continue to sell with the debtor on terms equal to or better than prepetition terms. The dollar amounts sought are high. WorldCom Inc. was authorized to pay vendors up to $70 million. The average relief granted to a midsized debtor has ranged from $8 million to $25 million. The responsibility to define the vendors typically has been placed in the hands of the debtors. When a company files for bankruptcy, it reviews a list of its vendors and decides which ones are critical in order to stay in business.

Another strategy for a debtor is not identifying their critical vendors in court pleadings, which are public documents, to avoid alienating those vendors who don't make the list. It seems the leverage of the critical vendor request may be shifting from the vendor to the debtor. The vendor may hold out continued sales to the debtor thereby threatening the debtor's ongoing operations, perhaps only to find a replacement vendor who qualifies as a critical vendor.

The Trade Claims Cap

The critical vendor doctrine has evolved from the debtor requesting a particular vendor be paid immediately as a critical vendor, to the debtor requesting a class of vendors qualify as critical vendors, to the debtor requesting the bankruptcy court establish a critical vendor "trade claims cap". For example, in the United Airlines Chapter 11, the carrier requested that the bankruptcy court pay trade claims totaling $35 million as critical. United Airlines did not identify the vendors it would deem critical. Rather, United Airlines requested the court authorize payment of a class of vendors it deemed critical which represented about 14% of vendors unsecured claims. United Airlines did not propose to pay in full each vendor deemed critical, but only the minimum for the vendor to continue selling on credit.

The courts application of the critical vendor doctrine continues to evolve. Debtors more frequently request courts' approval of the critical vendor program. Where the doctrine is approved, courts reason, both the debtors and creditors stand to gain something. The critical vendor benefits by receiving early payment on its prepetition claim. The debtor and its vendors benefit by receiving needed product on credit, which may lead to a successful reorganization. A vendor being deemed an essential vendor can have a dramatic impact on the account. The credit professional is not forced to wait what may turn out years for uncertain payment from a reorganizing debtor—so get on the list!

DIP FINANCING

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DIP check from the debtor for the sales. However, the debtor defaulted on the DIP financing, and the DIP lender pulled the financing and refused to honor the debtor's check to pay the vendor for the postpetition sales. The case converted to Chapter 7. The vendor went unpaid for the postpetition credit sales.

As the debtor had no assets to pay the vendor, the vendor sued the lender to recover for the unpaid shipments. The vendor claimed, among other things, that: (1) the DIP lender was obligated under the DIP financing to provide financing for the debtor to purchase goods in the ordinary course; and (2) the DIP lender was unjustly enriched by its shipment of goods and refusal to honor the check; and (3) the DIP lender breached a duty of good faith and fair dealing with the vendor by failing to honor the check; and (4) and that the DIP lender fraudulently induced the vendor to sell goods on credit to the debtor.

The bankruptcy court rejected the vendor's argument that the DIP lender was absolutely obligated to finance the debtor's purchase of vendors' goods. Rather, the court reviewed the court order (a public document) and determined that the DIP lender had discretion in financing and the events of the debtor's default. The DIP lender could pull the financing, the court ruled, and vendors would be at risk for the postpetition credit sales.

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DEALING WITH THE INSOLVENT CUSTOMER

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They had a long trade relationship, wherein the vendor would sell the debtor on credit and the debtor would repay the vendor based on its cash flow. The debtor sold the product purchased from the vendor on credit, using the proceeds to pay other creditors. The debtor encountered financial difficulties and filed an individual Chapter 13. The vendor's open account for product sold on credit was unpaid.

The vendor was scheduled by the debtor as an unsecured creditor. The vendor filed a lawsuit with the bankruptcy court contesting that its claim should not be discharged as the debtor defrauded and embezzled the proceeds. The vendor also argued that its claim should not be discharged through the bankruptcy as the debtor owed a fiduciary duty to the vendor which was breached when the debtor paid other creditors with the proceeds from the sale of product it provided on credit.

Elements Of A Nondischargable Action

Should a debtor that files bankruptcy defraud a vendor, the vendor may be able to have its claim "ride through" bankruptcy. A vendor may also seek to have its particular debt to be ordered non-dischargable, or object to the debtor's discharge, wherein all of the debtor's debts are ordered non-dischargeable.

The most common causes of action to exclude particular debts from discharge are: (1) fraudulently incurred obligations; (2) fiduciary fraud and embezzlement; and (3) willful and malicious acts.

The nondischargable provisions provide that the debtor must be an individual. Thus, if the vendor sold to a sole proprietorship, or holds a personal guarantee on a sale to a corporation, LLC or partnership, the vendor has a claim against an individual. There are no nondischargable claims against a corporation, as the corporation is not entitled to a discharge in bankruptcy. If the vendor sold to a corporation, and the insider of the corporation filed bankruptcy, the vendor may still have a nondischargable claim against the individual, but must establish an alter ego claim against the insider.

Where property is obtained by the debtor's false pretense, false representation or actual fraud such claim may be excepted from discharge. Under the fraud nondischargeable provision, the vendor may establish either oral or written fraud by the debtor. With the oral fraud, the vendor must establish fraud and its reasonable reliance on the debtor's representation. If the fraud is in writing, the vendor must establish that the false financial statement is materially misleading and the vendor reasonably relied on the false financial statement.

The vendor may also have its claim ride through bankruptcy where it can be established that the debtor defrauded the vendor while in a fiduciary capacity. The vendor may also have its claim ride through bankruptcy where the debtor committed a willful injury. Courts have found that where a debtor has converted a vendor's property, such as collateral subject to a purchase money security interest may result in a nondischargable claim.

If the vendor seeks to deny a debtor's discharge, objections may be based on the following: (1) the debtor transferred, concealed or destroyed property within one year before the bankruptcy filing or any time after the filing; (2) the debtor concealed, destroyed or failed to keep books and records; (3) the debtor made a false oath or withheld information from an officer of the estate; (4) the debtor is unable to explain loss of his property; (5) the debtor has received a discharge in a prior bankruptcy within six years; and (6) the debtor has had a discharge waived or denied in a prior bankruptcy case. Many of the grounds for objecting to a discharge may also constitute federal crimes. Be mindful that the vendor must act quickly with commencing these claims, which may require filing 60 days after the First Meeting of Creditors.

Debtor May Discharge Vendor's Claim

The *Wright* court determined that the vendor failed to prove that the debtor defrauded the vendor by selling its product and using the proceeds to pay other creditors. The court found that the vendor did not take a security interest in the goods nor the proceeds from the sale of the goods. The court also noted that the vendor did not require the debtor to segregate the proceeds in a separate account. Further, the court found that the vendor failed to take steps to protect their product when they believe the debtor may be converting the product.

Issues for the Credit Professional and Dischargeability Litigation

In crafting the non-dischargeabilty exceptions to the Bankruptcy Code, Congress intended that a dishonest debtor might not evade its debts. With these provisions a vendor may be able to have its debt ride through bankruptcy. The credit professional must be mindful of the time limits to timely file a complaint to have the particular debt or all of the debts excepted from discharge.

1. 282 B.R. 510 (Bankr. M.D. Ga. 2002)

DIP FINANCING

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As to the vendor's claim that the DIP lender was unjustly enriched, the unjust enrichment rule provides that when a vendor's goods or services that preserve the value of the secured creditor's collateral, the secured creditor's acceptance may be a basis to hold the lender liable for the value of goods or services. Courts look to either inequitable conduct by the secured creditor or the nature of the unsecured creditor's contribution to the collateral.

Where a lender encourages transactions between the debtor and unsecured creditor and benefits from the goods and services, there may be an opportunity for the unsecured creditor to recover from the secured creditor. If the lender has an active hand in promoting a credit transaction that goes unpaid, courts reason that the lender should not escape when a vendor is left with unpaid invoices. However, the *Forman Industries* court found:

"We are not, however, willing to assert as a general proposition that a secured lender who refuses to provide debtor with post-petition financing to pay for goods that is used to liquidate the lender's collateral thereby *necessarily* is unjustly enriched." *Forman Industries*, 280 B.R. at 615.

The vendor contended that the DIP lender had a duty to deal fairly with vendors extending credit postpetition and the DIP lender breached this duty when it failed to honor the check payable to them. The court rejected the argument finding that the DIP lender was not absolutely obligated

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THE USA PATRIOT ACT: A PRIMER TO COMPLIANCE REQUIREMENTS

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are required to share information and provide Suspicious Activity Reports ("SARS"). The USA PATRIOT Act requires branches of the federal government to share information with financial institutions to assist in the identification of suspected terrorism and money laundering activity. This requires a financial institution to designate an employee to receive information on suspicious activities, and if necessary, monitor suspected accounts. In addition, financial institutions may corroborate amongst one another concerning suspicious activity; however, notice must first be provided to the appropriate government authority. If a governmental authority requests information, then the institution must provide the information within five (5) days of the request. Fortunately, the drafters of the USA PATRIOT Act had the foresight to provide a "safe-harbor" for monitoring and reporting suspicious activity and providing information requested by the federal government.

Currently, the Treasury Department is promulgating regulations that will set forth minimum standards to open an account. As to foreign nationals and foreign companies, contemplated regulations include the issuance of identification numbers, similar to tax identification numbers, as a prerequisite to opening an account. Regulations and compliance procedures should be approved and mainstreamed later this year.

<u>USA PATRIOT Act and the Office of Foreign Assets Control</u>

Despite designation as a financial or non-financial institution, an entity is required to implement due diligence procedures for foreign accounts pursuant to a series of laws imposing sanctions against certain foreign nations. These laws are administered through the Office of Foreign Assets Control ("OFAC"). Generally, diligence procedures include record keeping procedures to identify foreign accounts to assure that any delivered product or services do not benefit a sanctioned foreign nation. A word of caution – a U.S. entity, and its foreign subsidiaries, may violate the law by exporting goods or providing financial services to an otherwise valid third country (e.g., Canada), if that third country directs those goods to a sanctioned country (e.g., Cuba).

<u>Suggestions for the Credit Professional</u>

The underlying purpose of the USA Patriot Act, and other legislation enacted to protect national interests, is identification of customers and their activities. Although this may sound of "big brother" and contrary to the privacy that we've grown to cherish, its purpose is generally benign and targeted toward the threats that we confront in the world today.

A good start to compliance, for non-financial institutions and financial institutions alike, is to know your customer and acquire knowledge of their business operations. In addition, institutions should periodically cross-reference lists published by government agencies listing banned individuals and foreign nations. Other measures should be implemented if your business is determined to be a financial institution.

<u>Sanctions for Non-Compliance</u>

Pursuant to the USA PATRIOT Act, if a financial institution fails to implement a compliance program, then fines may be assessed at $25,000 per day for civil violations, or $250,000 to $500,000 per day if the failure is criminal and based on a pattern of illegal activity. Due diligence violations, or failing to "know" your customer, may result in a penalty equal to double the amount of the transaction. Violations of OFAC regulations range from $10,000 to $1 million per occurrence and 10 to 12 years imprisonment.

In conclusion, the USA Patriot Act is a complex statute with new and developing regulations. It is important to note, that the USA PATRIOT Act was passed in a hurried response to the September 11 terrorist attacks, and as a result, its scope is constantly evolving. As a result, institutions must maintain a sharp eye on its development.

DIP FINANCING

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to finance the debtor's postpetition debts, but had discretion if the debtor defaulted on the financing terms. Further, the court found there was no evidence that the DIP lender decided which vendor should be paid, but rather it was the debtor's decision.

As for the vendor's claim that the DIP lender fraudulently induced it to sell on credit, the court rejected the claim finding that DIP financing order did not absolutely obligate the lender to finance the debtor's postpetition purchases. The court did not find any evidence that the lender misled vendors or made false misstatements to vendors.

Protecting Your Postpetition Credit Sales

The *Forman Industries* ruling reminds creditors that DIP financing does not necessarily guarantee payment of postpetition credit sales. The Bankruptcy Code encourages vendors to sell on credit postpetition by offering an administrative priority claim (administrative priority means payment before general unsecured creditors) should the postpetition sale go unpaid. But as *Forman Industries* shows, an administrative claim for a postpetition credit sale may go unpaid if the debtor is administratively insolvent.

Given this risk, are there alternatives to reduce risk with a postpetition sales? A vendor may simply insist on COD and CIA sales, however, the customer may move its business to a competitor. Some Chapter 11 debtors are using trade liens to encourage vendors to sell on credit. The trade lien is usually junior to a DIP lender, which means that the vendor is paid only after the DIP lender. A vendor may insist on selling on a secured basis, such as with a purchase money security interest. The credit professional must weigh the alternatives before agreeing to sell on credit postpetition.

TAKE THE HOLISTIC APPROACH TO IMPROVE COLLECTION PERFORMANCE

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Pricing and Terms of Sale

- **Terms and pricing are a sales tool but….**

In tough times, Sales and Marketing uses credit terms and aggressive pricing as a tool to gain market share. It is the responsibility of a Chief Financial Officer to ensure that the credit manager works within this framework and is part of the effort to increase company revenues. However, it is a two way street. The company's cash flow requirements, administrative capacity and costs must be part of the equation. Coordination and a high level of communication between sales and credit and collections are essential.

- **Complexity breeds administrative problems**

Complex or dynamic pricing policies create a sales administration nightmare. It is critical for Sales Administration and Credit and Collections to play a part in how these policies are formulated. Competitive deals are needed to gain market share. However, if for example, systems supporting pricing tables are not there, the result is manual effort and misunderstanding. This affects both internal operations and even worse, relations between the company and its' customers.

As pricing and terms policies are being developed all parties responsible for dealing with the aftermath need to participate. The credit manager needs to raise issues and help come up with solutions.

- **A slave to two masters**

Any company granting trade credit is a slave to two masters. One is the cost of funds and lost working capital opportunity and the other is the risk of non-payment by debtors. Extended terms have both a cost and a risk that should be quantified as deals are being developed. The result will be knowledge based business decisions that consider both the competitive marketplace and the financial consequences.

Credit Approval and Review

- **Implement an integrated credit policy, signed off by senior management**

A credit policy must address both the company's need to generate revenue and the level of risk necessary to remain competitive and meet financial objectives. The credit policy cannot be developed in a vacuum.

The credit manager must be involved from the start and thoroughly understand the company's objectives and channels of sale. The needs of all areas in the company should be considered.

There will always be exceptions. The basis for making "business decisions" on an exception basis should be part of the policy. It is essential for the policy to be signed off and supported by senior management of each area involved. Yes, this includes Sales. Once the policy is agreed to the road map is set.

- **The Credit Manager must be involved from the beginning**

The Credit Manager must be part of the sales process. It is to sales' advantage to include the credit manager as new channels or customer relationships are being contemplated. A preliminary credit review of sales prospects can help sales understand the customer's potential and if special credit arrangements may be required.

- **Obtain a complete Credit Application**

Complete information on the customer is critical if there is a collection issue. The information on the credit application becomes a valuable resource to contact the company's principal or a senior executive, bank contacts or other trade partners originally listed as trade references.

- **No surprises on special credit requirements**

It is much better for everyone, including the customer, to know about special requirements up-front. Why waste precious sales time on accounts with low potential. If cash terms or some form of security will be required, it is better to communicate this before the sale is in the forecast.

- **"We never say no…. Yes but how?"**

The credit manager must enter the discussion with an attitude of **"we never say no, we say yes but how".** With this in place credit will no longer be perceived by sales as the "sales prevention department" or some obscure accounting function. The aim is to motivate sales to seek information from the credit department by being solutions oriented.

Sales must understand both the risks and opportunities that come with the sale. There is the story about the Sales Manager who was upset with the Credit Manager for turning down credit approval on a hot prospect. Several weeks later the Sales Manager learned the target company shut its' doors. At the next sales meeting he explained to his team, "I was angry because there was no commission to buy the new car I wanted. Now I realize the Credit Manager saved my mortgage"

- **Credit reviews are essential**

Continued credit worthiness must be reviewed on an ongoing basis, both at the customer and portfolio level. This will help to direct sales towards high potential channels and customers and also identify areas with a high risk of delayed payment or bad debt.

There are excellent software tools in the marketplace to customize credit policies and automate the analysis. The credit manager can incorporate in the evaluation financial information, historical payment data and ratings from major trade credit organizations. Subjective criteria important to the analysts can be weighted into the model as well.

- **Examples of when a review should take place:**
  - Periodically based on the dynamics of the market. (quarterly, bi-annually, but at a minimum annually)
  - If there is a significant increase in sales volume
  - If the payment pattern shows deterioration
  - Negative financial results reported
  - Poor trade ratings from industry trade interchange groups or rating services
  - Change in senior management or ownership
  - High number of trade reference requests
- **An effective credit hold is no secret**

The credit-hold process should be well communicated within the organization. The extent to which customers are given advance notice and the degree to which salespeople are used for collection, varies between industries. It is critical however for sales to know a credit hold is being imposed. This should be communicated as far

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TAKE THE HOLISTIC APPROACH TO IMPROVE COLLECTION PERFORMANCE

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in advance as the situation allows.

- **Credit hold is a collection tool and can reduce bad debt exposure**

For maximum effect, when a credit hold is imposed, pending shipments are held and order taking is stopped. Most companies handle this manually. Administering this process effectively is critical to both motivate slow payers to pay current and to reduce the risk of non-payment. To the extent that the credit hold process can be incorporated into system based controls it should be.

- **Network, Network, Network…. Education, Education, Education**

Credit professionals should take advantage of networking and trade interchange groups such as those offered by Affiliates of the National Association of Credit Management (NACM) and Reimer. This helps keep the pulse on customer risk and industry trends. The NACM Professional Certification Program provides excellent education opportunities.

Order Entry

- **Accuracy, visibility and timeliness are key**

Order administration accuracy and integration with company pricing, terms and credit policies is key. This is where administrative discrepancies begin. As companies migrate to electronic data interchange and transaction volumes increase, problems reach a new level of complexity and financial impact. For example, if stale dated pricing or incorrect terms or product codes are used, the invoice simply won't be right. If the invoice is wrong the customer will short pay, deduct or even worse use the discrepancy as an excuse not to pay at all.

- **Do it right the first time**

Processes and system safeguards need to be in place to reduce the opportunity for error. If errors occur there needs to be timely visibility so corrections can be made. Aside from the internal impact and cash flow consequences, this is critical to customer care. Everyone in the organization must work together to do it right the first time.

- **Create a thorough and accurate customer master**

In order for billing activity to flow smoothly through the customer's accounts payable process, it is critical that all information on the invoice be accurate. This starts with an accurate customer master. If customer contact information or bill to and ship to detail are inaccurate errors and delays will result

Billing

- **It's the format ……**

Most billing today is accomplished with paper invoices. As billing is converted to an electronic format it is essential for both parties in the transaction to do thorough upfront work. This will insure both the buyer and seller's system communicate accurately.

For those transactions billed by hardcopy invoice there are pitfalls that can delay payment.

- Eliminate delays in mailing the invoice. Depending on how the customer's accounts payable policy and system are set up, the date of receipt of invoice may have a lot to do with when payment is made. Timely mailing is particularly important in industries with short terms of sale.
- Clearly state the terms of sale or due date on the invoice.
- As simple as it sounds, make sure the invoice is sent to right location.
- Clearly state the "remit to" address.
- Avoid payments coming directly to the office. Do not include the company address on the invoice. A contact phone number/email address will suffice. Checks sent to a bank lockbox are deposited faster. Checks going to offices get lost or worse, they can be intercepted and fraud becomes an issue.

- **Question the need for statements**

Companies pay invoices. Statements may clutter the desk in accounts payable and take away valuable processing time.

- **Consider a "Summary Invoice"**

If there is a high volume of invoice activity consider providing the customer a summary invoice. With proper backup this can reduce the time required for accounts payable to process payments.

- **Accuracy cannot be overemphasized**

Determine root causes if there are repetitive errors in pricing, product description, quantity, ship to location etc. Quantify the issue and report the problem quickly to all appropriate areas in the organization. Put a meeting together if necessary to brainstorm corrective action and fix the issue.

- **Migrate to electronic bill presentment**

This saves processing time and increases staff productivity. Technologies are available that eliminate mail delay and automate the billing payment relationship. The Internet has opened electronic interchange as a practical solution to companies of any size. Although this does not fit every industry or customer relationship opportunities should be sought after.

Customer Service

- **Prioritize "customer facing" processes and events**

The customer relationship is a critical component of cash flow and risk management. People not technology, ultimately handle exceptions, respond to questions and go the extra mile when asked. Attention to customer needs is critical. Any process step, document or personal contact directly between the company and the customer must be continually reviewed and adjusted to address customer requirements.

This takes good communication with the customer and internally between all areas servicing "customer facing" processes.

- **Organize sales, customer service, collection, dispute reconciliation and cash application teams with common customer assignments.**

If a team approach is taken issues will be addressed from all critical viewpoints. Develop people in each functional area as specialists for specific customers, types of customers or customers within particular regions. Emphasize cross-functional communication and problem solving. The aim is to provide one face to the customer no matter the issue.

Cash Application

- **Utilize lockbox arrangements and keep up with customer remittance policies**

Most payments are still made by check. In spite of technological advances the number of checks processed through the US banking system each year continues to increase. The best defense against today's sophisticated disbursement tactics are strategically located lockboxes. Mail float delay is a factor in cash flow for both buyer and seller. By understanding where payments

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TAKE THE HOLISTIC APPROACH TO IMPROVE COLLECTION PERFORMANCE

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are coming from, the creditor can establish banking arrangements to minimize mail float.

- **Take advantage of banking technology**

Major lockbox banks provide scanning and same day online viewing of remittance advice. This allows for payments to be deposited as delivered and provides cash appliers and collectors the ability to review remittances in advance of hard copy documentation.

Scanned or electronically imaged remittance detail can be archived for future research. There are choices on how to access the information, by the Internet; or the bank can provide a CD or other electronic record.

- **Take advantage of autocash technology**

Autocash arrangements facilitate application of customer remittance detail directly to the accounts receivable system. If there is a high degree in item matching this can drastically reduce the need for cash applications headcount and speed up the process.

- **Consider strategic outsourcing**

There are excellent service providers among the lock box banks. In some industries credit card sales can provide third party resource, particularly on low dollar, non-strategic business.

- **Take advantage of data on remittance detail**

The customer identifies process and product issues each time a deduction is taken. Tie this valuable information into your process improvement efforts. By understanding root causes as early in the process as possible, the credit professional can provide valuable information throughout the organization. Data gathered will also provide agenda topics for cross-functional process improvement teams.

Collections and Dispute Resolution

- **Collections is not an accounting function**.

Many companies make a mistake by not distinguishing between what is required by the accounting function and collections. Effective collection requires actionable information. The collector and manager must have easy access to up to date information on each customer such as, the outstanding balance, aging, associated risk, payment history, promises made, open disputes and notes of recent contacts.

- **Effective collections is proactive**

Tools must be available to both collectors and management to prioritize contacts. The workday should be structured to maximize customer contact and follow-up. Good account coverage is needed, however, collectors should not spend valuable time contacting volunteer payers or performing unnecessary clerical tasks.

Collections and Dispute Resolution (continued)

- **Utilize automated collection tools**

Major ERP solutions provide collection and deduction management capabilities to a limited degree. For both ERP users and smaller organizations there are scalable "bolt on" solutions in the marketplace with a wide-range of functionality.

These systems provide access to anyone in the organization with a need to know. The Internet opens information to field or home offices and also enables customers to access their own activity. Providing self-help tools within the company and to customers improves productivity and saves time.

Key functionality to look for includes:

- o Ability to assign groups of accounts to a collector or reconciliation analyst
- o Ability to define optimal collection strategies based on a customer's level of risk and payment habits.
- o Daily prompting of collection contacts applying strategies to open balances.
- o Allow user to enter contact notes with automated tools to reduce keystrokes.
- o Automatic prompting for follow-up on promises
- o Provide the option to contact by phone, or customizable fax, email or letter.
- o If the need is there, provide auto-dial capability
- o Provide problem resolution workflow tools that allow user to assign problem reason codes and identify the responsible resolver in the organization.
- o Track historical information such as customer payment history, disputes by type, status and timeframe from identification to resolution.
- o Ability for authorized individuals in the company or the customer to access account information and obtain copies of documents such as invoices, credit memos, statements etc.
- o Robust management reporting tools.

- **Eliminate Paper based research**

There are services in the marketplace that can archive documents and provide authorized users with Internet access. Using indexing techniques, data elements can be rearranged to provide ad-hoc reports for use in customer dispute research or even for sales and marketing purposes. These services can accept hardcopy documents for scanning, CD's or tapes or electronic file transfers.

Use of this technology can save significant time in research and resolving disputes. This provides additional time for collection staff to focus on cash generating tasks.

- **Visit customers regularly**

A good relationship with the customer can be the distinguishing factor between creditors who get paid on time and those who do not. It is important for a variety of reasons to conduct on-site visits. You are no longer just a voice on the phone. By being at the customer's location, you get a first hand look at the level of activity and get to meet the staff and review customer processes. You learn something on every visit.

If resources allow, the credit collections manager should consider also bringing the collector or the deduction specialist.

Additionally, a team effort, including sales, customer service, operations and information technology, may be the best way to resolve process or systems issues involving both parties. This of course depends on the size and complexity of the relationship and the perceived payback.

- **Meet with Sales regularly**

Sales can provide a set of ears and eyes in the field for the collection organization. Participate in Sales Team meetings. Communicate issues involving their accounts. Seek sales input and help them understand how important it is to report back to you on changes in customer condition or other cash

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TAKE THE HOLISTIC APPROACH TO IMPROVE COLLECTION PERFORMANCE

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flow related issues.

- **If you can't measure it how can you manage it**

Establish metrics that define success in collections and dispute resolution. Keep in mind that everyone within the quote to cash process should have skin in the game. This includes sales, operations and customer service as well as the finance functions.

It is interesting to report total Days Sales Outstanding (DSO) and to provide detail on the DSO current to terms, disputed and past due. This can be a real eye-opener to Senior Management who might not be aware of the impact of extended terms or the carrying cost of disputes.

Some metric examples:
- o Days Sales Outstanding
- o Best Possible Days Sales Outstanding
- o Average Days Past Due
- o Past Due Ratio
- o Specific Cash Targets
- ◊ Average Days to Resolve Deductions

- **Utilize strategic outsourcing and stick to core competencies that have a pay back**

Review collection and reconciliation activity to find areas that are best outsourced to a competent third party. In these times of tight staffs and budgets, collection departments need to focus on critical customer relationships and transactions. Review low dollar activity, non-strategic accounts and seasonal volume fluctuations. These can be handled by a third party and will probably save the company money.

- **Provide incentives for targets to be met or exceeded**

Incentives should be structured to include all who impact target achievement. This will also serve to bring different areas of the organization together as a team. Remember to have fun in the process. Targets should be a stretch but fair, achievable and be focused on group rather than individual performance.

Conclusion

To have a significant impact on incoming cash and collection results all parts of the organization must be devoted to the effort. Depending on the issue at hand, this could involve sales and marketing, operations, customer service, credit and collections, accounting and finance.

The company's credit and collection policies should address customer needs and the company's sales, and marketing and financial goals. Guidelines and exception policies should define acceptable terms of sale and credit risks. A mandate is required from senior management to make all this happen.

Using the "holistic" approach, issues can be quickly identified and cross-functional efforts employed toward improvements. As one of the few in the organization with visibility to all the factors involved, the credit professional can be utilized as a leader in the improvement effort.

1. Charles Schultz is a partner in Quote to Cash Process Consulting and the incoming Chairman of the Board of CMA.

DEFENDING A PREFERENCE CLAIM UNDER THE SOLVENCY DEFENSE: WHAT THE VENDOR MUST PROVE

(Continued from page 3)

Code does not condition the Chapter 11 filing on the business' insolvency. Generally, insolvency is a financial condition in which the sum of the entity's debts is greater than the fair value of its assets. A debtor is presumed insolvent 90 days before filing bankruptcy. If a vendor challenges the presumption, the burden is on the vendor to produce financial evidence to rebut the presumption of insolvency. There is no presumption of the debtor's insolvency more than 90 days prior to the bankruptcy filing.

Court Finds Debtor Insolvent

In *In re* Lids, the parties agreed to all of the elements necessary to avoid the transfer of the security interest as a preference, except whether the debtor was insolvent when the creditor perfected its security interest by filing its UCC-1.

As a starting point in establishing the solvency defense, the court noted that the creditor must present sufficient evidence that the debtor was solvent on the transfer date to rebut the presumption of insolvency. That evidence of solvency usually requires expert testimony. Complicating the question of solvency valuation, however, is that there is no GAAP method for measuring the insolvency of a company.

The parties agreed that the Balance Sheet Test (assets over liabilities) was to be used to determine solvency. The court found that in valuing the debtor's assets it would consider the sale price a willing seller would accept from a willing buyer if the assets were offered in a fair market for a reasonable period of time.

The creditor employed a financial consultant that prepared a report regarding the value of the debtor's assets as of the transfer date. In its report, the financial consultant relied on three valuation methods – adjusted balance sheet, market multiple, and comparable transaction – to establish the value of the debtor's assets.

The debtor objected to the creditor's balance sheet valuation as the debtor claimed it did not ascribe fair market value to its assets. The debtor employed its own financial consultant that valued the debtor's assets at far less. The debtor's analysis started with the book values and the estimated recoverable percent of each asset's value to determine the total fair market value of the debtor's assets. The court did not accept the creditor's balance sheet valuation.

The creditor's financial consultant also applied a Market Multiple Methodology to also value the debtor's assets. Under this methodology, net revenues and earning are multiplied by an appropriate range of risk-adjusted multiples to determine the debtor's total enterprise value. In its analysis, the creditor selected multiples by bench marking certain publicly traded companies, using quantitative and qualitative factors. The bankruptcy court did not accept the creditor's consultant's choice of multiples as they did not accurately reflect the comparable companies' values because the debtor had not been profitable while the other companies were.

The creditor's consultant also applied the valuation method of Comparable Transaction Methodology which is designed to yield the price the company would carry in the marketplace based on similar

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DEFENDING A PREFERENCE CLAIM UNDER THE SOLVENCY DEFENSE: WHAT THE VENDOR MUST PROVE

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transactions. The court also found this analysis unconvincing as it ignored that the debtor had not been profitable so it cannot be compared to profitable companies.

After the court determined the value of the debtor, it considered the liabilities of the debtor during the preference period. When conducting a balance sheet analysis, the court found that the fair market value of the assets is compared to the face value of the liabilities, including contingent liabilities.

Based on the values the creditor's consultant assigned to the debtor's assets and debts, the creditor's consultant concluded that the debtor's assets exceeded debts by several million dollars, and therefore was solvent. The debtor's consultant reached a far different conclusion, finding that the debtor's consultant estimated that the debtor's liabilities exceeded assets by a range of $8 million to $107 million.

The bankruptcy court concluded that the creditor's consultant's solvency report did not rebut the presumption of insolvency imposed under the preference provision of the Bankruptcy Code. As the debtor was found insolvent during the preference period, the creditor's lien was ordered unseated.

Conclusion

A vendor has a number of standard preference defenses to attempt to shield payments received during the preference period, from contemporaneous exchange, to ordinary course of business to new value. The vendor should also consider the possibility of raising the solvency defense. *In re Lids* shows that the solvency defense can involve complicated valuation issues that may require an expert, which may make such a defense quite expensive. To mount a solvency defense, a group of vendors may join together to share expenses to prove this defense that otherwise each would have to attempt to establish.

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Spring 2003

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

◊ Scott spoke to the ***Consumer Electronics Group*** in Las Vegas regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to ***NACM/Chicago-Midwest's National Musical Group*** in Anaheim, CA regarding ***Creditor's Rights.***

◊ Scott spoke to ***NACM*** via teleconference regarding ***Critical Trade Vendors.***

◊ Scott spoke to the ***National Food Suppliers Group*** in Las Vegas regarding ***Preference and Bank Developments*****.**

◊ Scott spoke to ***NACM Loss Prevention Group*** in Las Vegas regarding ***Accepting Credit Cards Through the Internet for Commercial Sales*****.**

◊ Scott spoke to **NACM/Texas' National Telecom Group** in Las Vegas regarding ***Creditors' Rights.***

◊ Scott spoke to ***NACM/Lousiville Industry Group*** in San Diego regarding ***Bankruptcy and Creditors' Rights.***

◊ Scott spoke to ***NACM/Tampa's Industry Group*** in San Diego regarding the ***Sarbanes Oxley Act.***

◊ Richard spoke to ***National Group Management's Food Group*** in Las Vegas regarding ***Hot Topics for 2003.***

◊ Scott spoke to ***Orange County Credit Professionals*** regarding ***Escheatment***.

◊ Scott spoke to the ***National Electrical Distributors Association*** in Irvine, CA regarding the ***Sarbanes Oxley Act***.

◊ Scott spoke to ***NACM/Connecticut's Fine Paper and Newsprint Group*** in Los Angeles regarding the ***Internet and the Credit Professional.***

◊ Scott spoke to ***Reimer Reporting Group*** in Las Vegas regarding ***Accepting Credit Cards for Commercial Sales***.

◊ Scott spoke to ***NACM/Maryland*** via teleconference regarding ***Perfecting Security Interests and Credit Applications***.

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