Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

Spring 2004
www.vendorlaw.com

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

CUTTING IN LINE: HOW SHAREHOLDERS AND BONDHOLDERS ARE BEING PAID AHEAD OF TRADE CREDITORS IN CHAPTER 11— THANKS TO THE SECURITIES AND EXCHANGE COMMISSION AND THE SARBANES-OXLEY ACT

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Headlines of corporate fraud within public companies, from Enron to Adelphia to WorldCom, prompted the U.S Congress to overwhelmingly pass federal legislation providing for accounting reform and requiring more accurate financial disclosure and reporting from public companies. This new federal legislation penetrates the area of corporate governance, which traditionally had been left to the states. The Sarbanes-Oxley Act of 2002 (SOA) was signed into law in July 2002 to combat the wave of accounting and financial reporting scandals and corporate bankruptcies.

SOA focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. SOA provides that the Security and Exchange Commission (SEC) enforces the legislation and has earmarked $766 million for SEC enforcement. A provision of SOA allows for the SEC to direct money collected from a fine and civil penalties of the company to a restitution fund for shareholders, not vendors. Prior to SOA, the SEC could only repay defrauded shareholders through money collected through disgorgement actions, as fines and civil penalties went to the U.S. Treasury.

WorldCom filed the largest Chapter 11, which was triggered by massive financial fraud. WorldCom agreed to pay shareholders and bondholders $750 million to settle fraud charges brought by the SEC under SOA. The settlement, the largest of its kind, is not only remarkable as to its size, but that shareholders, which are junior in priority to vendors' prepetition claims, and bondholders, that are equal to vendors' prepetition claims, are paid ahead of creditors. Under the plan of reorganization proposed by Worldcom, vendors received stock in the reorganized debtor.

The proceeds from the settlement going to shareholders and bondholders clashes with a fundamental principle of the bankruptcy laws, that of the long-standing priority scheme wherein creditors are paid ahead of shareholders. Indeed, until unsecured creditors are paid in full, which will not happen in Worldcom or Enron, shareholders are not to receive payment.

Nothwithstanding the priority scheme, shareholders are able to cut ahead of vendors' prepetition claims as the government is treated as a priority creditor and paid first. But the conflict with the priority scheme is that shareholders are rewarded at the expense of creditors. While shareholders and bondholders were defrauded by

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PRE-FILING INVESTIGATION OF DEFENSES TO A PREFERENCE ACTION—WHOSE JOB IS IT ANYWAY?

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It is clear that a plaintiff is obligated to make reasonable inquiry of the factual and legal basis of a preference claim before filing a preference action. That is, the plaintiff must investigate the existence of the *prima facie* elements of a preferential transfer before commencing the action. These elements include whether the alleged preferential transfer was on account of antecedent debt, made while the debtor was insolvent and within 90 days before the petition date. These elements are rarely contested.

A more important issue, from a creditor's perspective, is whether the plaintiff is under a duty to analyze the creditor's available affirmative defenses, such as new value and ordinary course of business. In the recent case of *In re Berger Industries, Inc.*, the bankruptcy court from the Eastern District of New York examined this issue.

In *Berger Industries*, the debtor filed a complaint against Artmark Productions Corp. seeking recovery of $177,631.36. Artmark asserted new value and ordinary course defenses to the action. The bankruptcy case was hotly contested, lasting nearly 6 ½ years. At trial, giving credence to Artmark's new value analysis, the debtor reduced its claim for preferential payments to $55,029.37. Artmark succeeded at trial and the bankruptcy court dismissed the ac-

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BEATING THE BANKRUPTCY PREFERENCE: MUST THE NEW VALUE REMAIN UNPAID?

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The Bankruptcy Code vests the trustee with far-reaching powers to avoid transfers and transactions prior to a bankruptcy filing. The power to avoid preferential transfers is one of the trustee's most potent weapons. The Bankruptcy Code defines a preferential transfer expansively to include nearly every transfer by an insolvent debtor during the preference period. The preference period concerns all transfers made by the debtor 90 days prior to the commencement of the bankruptcy case.

The purpose of the preference provision is two-fold. First, creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain vendors by the requirement that nay creditor that receives a greater payment, than similarly situated creditors, disgorge the preference so that like vendors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period are avoidable. Congress has carved out seven exceptions to the trustee's recovery where the transactions replace value to the estate previously transferred. A majority of courts hold that Bankruptcy Code section 547(c)(4) embodies a subsequent advance rule. Under this exception, Congress excepts from avoidance those transfers to a creditor who subsequently extends goods or services (or credit for those goods or services) to the debtor. For example, in a simple application of the subsequent advance rule, say on January 1 the debtor pays an unsecured creditor $10,000 for goods furnished. On February 1, the creditor provides the debtor an additional $10,000 in goods on open account (no purchase money security interest is taken in the goods). On March 1, the debtor files bankruptcy. The January 1 payment made within 90 days before bankruptcy is avoidable assuming that the criteria of section 547(b) were met.

However, because the subsequent advance of goods replenished the estate, the subsequent advance rule permits the vendor to set off its February 1 advance against the preference. The vendor is left with an unsecured claim for $10,000. The subsequent advance rule has its most frequent application with the pattern where a vendor provides goods or services on open account and the debtor repays at various points during the preference period.

A dispute has split courts as to whether the subsequent advance rule applies when the subsequent advance provided by the vendor has been repaid by the debtor. The issue breaks down to one where the debtor contends the vendor should receive subsequent advance credit only for those invoices that remain unpaid as of the bankruptcy filing, while the vendor contends itshould receive credit for all subsequent advances made during the preference period, whether paid or unpaid as of the petition date, so long as the transfer is "otherwise unavoidable."

A majority of courts have adopted the position that the subsequent advance must remain unpaid. A number of courts have rejected this view and hold that the subsequent advance need not remain unpaid. Rather, these courts hold section 547(c)(4) requires only that the debtor not make an "otherwise unavoidable transfer" on account of that advance.

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FROM THE PUBLISHER:

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Guest Column

FRAUD: "WHEN THE UNBELIEVABLE HAPPENS"

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They say a truly honest man is one you can play craps with over the phone. Today's headlines make us wonder where the honest people in business have gone.

We are all familiar with the basic facts surrounding the Martha Stewart case. If you are like me, you found her recent conviction on all charges both startling and baffling. How could someone so revered and trusted in the public eye suddenly be convicted of crimes of deception. Why would she risk so much for a relatively small gain.

More importantly, what lessons can we take from this to our daily life as a credit professional? Who can you trust? What should you look for? What preventative steps can be taken? There are many lessons in the recent corporate scandals reported in the press and they are more relevant today than any time in the past.

Why Should I Care?

The National Association of Credit Management (NACM) Asset Protection Group (APG) estimates the following costs of fraud in the U.S.

- Business identity theft grew 70% from June 2002 to June 2003.
- Suppliers take in more than $18 billion in bad checks annually.
- Fraud cost American companies $400 billion in 2003.
- The U.S. Chamber of Commerce reports that $50 billion is lost annually due to employee theft and fraud.

Do you really know what the cost is for your company?

What is Fraud?

Fraud comes in many forms. It can be an internal issue precipitated by a trusted employee, or committed by an organization or individual purchasing your company's

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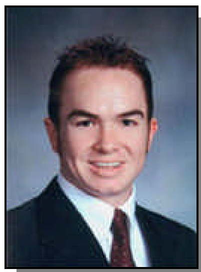
HOW ARE THE BANKRUPTCY COURTS TREATING RECLAMATION: A RECENT REVIEW



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How strong is a vendor's reclamation right under the Bankruptcy Code? Reclamation is the vendor's right to reclaim possession of goods delivered to an insolvent buyer. The remedy of reclamation is used when an unsecured vendor is unable to retrieve goods or stop them in transit. The Bankruptcy Code requires (1) that the vendor's demand for reclamation be made in writing; and (2) in certain circumstances extends the notice period from ten to twenty days. The Bankruptcy Code also provides the bankruptcy court with broad discretion to grant a vendor a lien or priority claim in lieu of the right to reclaim. The court uses this power to permit the debtor to utilize the goods in reorganization.

Vendors must consider that their reclamation rights in bankruptcy may be altered. For example, the bankruptcy court may find a reclamation claim valueless since the vendor's rights to reclamation under the Bankruptcy Code are subordinate to the rights of a prior secured creditor with a security interest in inventory. A holder of a prior perfected, floating lien on inventory that is a good faith purchaser will have superior rights to the reclaiming vendor. Although the right to reclamation is subordinate to a good faith purchaser, the reclamation right is not automatically extinguished, but instead will be "relegated to some less commanding station."

The vendor's "right to reclaim depends on the value of the excess goods remaining once the secured creditor's claim is paid or released." Accordingly, if the goods are subject to the rights of a good faith purchaser or prior undersecured creditor, the vendor may not be entitled to recover possession of the goods, nor will it automatically be granted an administrative claim or lien for the value of the goods.

As a vendor, you can protect yourself by performing a balance sheet analysis of the debtor before selling on credit. If the debtor does not have enough assets for its secured creditors, your reclamation right may no longer be recognized because of the bankruptcy.

This is the situation presented in *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003). In *Dairy Mart*, the debtor was a party to a revolving credit agreement, which was guaranteed by a lien on the debtor's property, including the inventory. After the bankruptcy filing, the debtor acquired a new facility. The new facility was secured by a first priority lien on and security interest in all property of the debtor already subject and subordinate to valid and perfected liens and a security interest of the bank pursuant to a prepetition credit agreement. The bankruptcy court entered a reclamation order that provided "any reclamation claim allowed. . . shall be treated as an administrative claim, but only to the extent of the value of the right of reclamation. . ."

The debtor objected to certain reclamation claims on the ground that the claims were subject to the interest of the bank who held a prior perfected, "floating lien" on the debtor's inventory, and that when the bank's lien was paid, the interests of the reclamation claimants were rendered valueless. As such, the debtor asserted that the claimants were not entitled to an administrative expense priority. On the other hand, the reclamation claimants argued that the debtors still had the goods when the reclamation demand was made and that the bank's claim was not paid from a sale of the goods.

The bankruptcy court found that the value of the reclamation claim is dependent upon what it would be worth regardless of the bankruptcy after the superior claim has been paid. Essentially, vendors will be left with general unsecured debt despite their reclamation demand if the goods subject to the reclamation demand are sold, and the proceeds used to satisfy the secured creditor's claim.

The bankruptcy court will always evaluate the reclaiming vendor's rights under non-bankruptcy law because bankruptcy law does not enhance the vendor's reclamation rights.

In the *Dairy Mart* case, the bankruptcy court had to determine whether the proceeds of the reclaimed goods were applied to satisfy the secured loan. The bankruptcy court found that "at the time that [the

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THE CREDIT DEPARTMENT, THE SALES FORCE AND SARBANES OXLEY: A UNIQUE RELATIONSHIP THAT MAY BE SCRUTINIZED IN LIGHT OF RECENT FEDERAL LAW

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One of the key responsibilities of the credit department is to work closely with the sales force to facilitate making the sale. The traditional view of the credit department simply considering an applicant's request for credit, analyzing objective criteria and then declining the sale should the applicant not meet the objective criteria, is no longer acceptable. Likewise the notion of the sales force and credit department incessantly fighting over customers' credit terms is giving way to a collaborative effort of the two groups ultimate objective of making a profitable sale. Often the credit professional works closely with the sales force in formulating a customer's contract, while managing credit risk.

Evidence of this symbiotic relationship is that more credit professionals are making customer visits with the sales force to fully manage the customer relationship. Highlighting the credit professional's broadening responsibilities is the shift in the role of the credit professional, from the title "credit executive" to "relationship manager".

Given the evolving collaborative relationship with the sales force, the credit professional may be quite familiar with the contract terms, including any ancillary, or side, agreements promised by the sales force. As the credit department and sales force's objectives coalesce, what should the credit professional be concerned about in light of the Sarbanes Oxley Act (SOA)? SOA's focus is on how a company recognizes and reports revenue. How does this central principle of SOA impact the credit department and sales force, especially with ancillary agreements to a contract promised by the sales force and understood by the credit professional?

SOA was enacted to combat corporate fraud. Recent reports of corporate fraud, from Enron to WorldCom to Global Crossi-

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The Subsequent Advance Rule

The subsequent advance rule prohibits recovery of an otherwise voidable transfer if (1) the vendor extended subsequent, unsecured, new value for the benefit of the debtor, and (2) the extension induced an "otherwise unavoidable transfer" from the debtor to the vendor. A vendor has the burden of establishing these elements. The subsequent advance rule is Congress' answer to protect the running account vendor. Under this analysis, a single transfer is not analyzed in isolation from the overall course of business between the vendor and debtor. The basis for maintaining the open account is the debtor's entire financial picture and not the debtor's most recent payment.

The following policy objectives support the subsequent advance rule: (1) to encourage vendors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy; (2) to promote equality among vendors; and (3) to reward vendors who actually enhance the bankruptcy estate during the preference period. Without the exception, a vendor who continues to extend credit to the debtor would be increasing its bankruptcy loss and, in effect, be punished for continuing to work with the debtor.

The Majority Rule: The Subsequent Advance Must Be Unpaid

In addition to the elements of the subsequent advance rule, those courts following the majority rule paraphrase the language contained in section 547(c)(4): "On account of which new value the debtor did not make an unavoidable transfer to or fro the benefit of such creditor" and require that the subsequent advance must remain unpaid. The inquiry posed is whether the vendor replenished the estate after having received a preferential transfer. These courts equate replenishment with the subsequent advance, providing the estate with a material benefit. A subsequent advance in an amount equal to the preference returns the preference to the estate.

However, where a debtor pays the subsequent advance (or the vendor retains a security interest in the advance,) there is not return of the preference and the estate is not benefited. In other words, the vendor has been paid more than it has supplied the estate, and this difference is subject to recapture by the trustee under the majority rule.

Permitting an offset for paid new value, the majority of courts reason, frustrates Congressional policy of equality of treatment of similarly situated creditors. If a vendor is able to claim the subsequent advance as an offset to the preference, this vendor would fare better than its fellow preference defendants. The vendor would not have to forfeit the preference, and it would already have been paid for goods it furnished to the debtor during the preference period after it received the preference.

The majority of courts also contend that this analysis promotes equality of treatment among creditors. The creditor, with invoices remaining unpaid as of the petition date, is permitted to file a proof of claim against the estate and share equally in any distribution on that claim with members of the general unsecured creditor class.

The Emerging View: The Subsequent Advance Need Not Remain Unpaid

A minority of courts reject the majority rule permitting application of the subsequent advance by a transfer which is otherwise unavoidable. Courts adhering to the emerging viewpoint find that the statute's plain language does not require that the subsequent advance remain unpaid, but only that the debtor not make an "otherwise unavoidable transfer" on account of that advance. Where the debtor does not make such an "otherwise unavoidable transfer," the subsequent advance should be available as a set-off against the preference. This means that a transfer could escape the definition of avoidable preference by failing to satisfy that section's requirements or by falling within one of the seven preference exceptions. If the subsequent advance is met with a transfer to the vendor that is unavoidable, the subsequent advance is unavailable for offset.

These courts also articulate that the policy objectives supporting the subsequent advance rule are better met when the paid subsequent advance is not subject to avoidance, as it would discourage creditors from dealing with debtors in financial straits.

The bankruptcy court in *In re Ladera Heights* stated that providing the lenient vendor a set-off encourages the vendor to extend new credit:

> "Penalizing creditors in a subsequent bankruptcy case for having continued to do business with such a debtor on a regular open account basis will undoubtedly discourage the very behavior that the preference exceptions purport to seek. Creditors are likely to cut off shipments to the debtor, destroying workout possibilities and forcing more debtors to file bankruptcy. The effect of the majority interpretation is that it "will cause creditors to abandon debtors in need."

As with majority rule, those courts embracing the emerging viewpoint are concerned with the statue's policy regarding a vendor's replenishment of the estate after each repayment by the debtor is itself an avoidable transfer, each subsequent advance returns value previously transferred.

There is also a practical problem with requiring the subsequent advance remain unpaid: As a debtor controls the amount of a transfer made after a subsequent advance, it may eliminate a subsequent advance defense by making a large preferential transfer just prior to filing bankruptcy to pay for the subsequent advance.

Further criticisms assert that the majority rule's rationale leads to inequitable results. Under the majority rule the trustee may recover the same amount twice; the creditor must both relinquish the payment received and lose the new credit extended. The court in *In re Irvine Ranch Farmers Market* noted:

"Assume IRFM made a preferential transfer of $50,000 to Ever-Fresh sixty days prior to filing bankruptcy. Subsequent to this transfer, Ever-Fresh gives IRFM new credit valued at $100,000. If bankruptcy were filed on this day; Ever-Fresh would be able to successfully assert a new value defense and retain the $50,000, under [the Trustee's] rule, the Trustee would be able to avoid the entire $100,000 transfer by the debtor. This result follows because none of the new value remains 'unpaid.' Under this rule, [the Trustee] may 'double count' the second preferential transfer. First, [the Trustee} may properly avoid the second

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$50,000 transfer to 'pay' for the new value, allowing [the Trustee] to recoup the first $50,000 which had previously been subject to a valid new value defense."

Of course, if a vendor has retained a security interest in a subsequent advance, or if the debtor has thereafter repaid the subsequent advance by means of "an otherwise unavoidable transfer," the subsequent advance rule prevents the vendor from relying on the new value exception because no effective replenishment of the estate has occurred.

A Sample Calculation

The table below applies the subsequent advance rule under the analysis employed by courts adopting the emerging viewpoint.

CHECK DATE	CHECK AMOUNT	GOODS SHIPPED	PREFERENCE
		10,000.00	0.00
1/01/04	10,000.00		10,00.00
		10,000.00	0.00
1/30/04	20,000.00		20,000.00
		20,000.00	0.00
2/15/04	30,000.00		30,000.00
		30,000.00	0.00
2/28/04	10,000.00		10,000.00
		10,000.00	0.00
3/15/04	20,000.00		20,000.00
		20,000.00	0.00
3/25/04	Bankruptcy Filed		
Total	$90,000.00	$100,000.00	$0.00

The "Check Date" column contains the date that the debtor delivered payments to the vendor for goods or services furnished (or credit for those goods or services). The "Goods Shipped" column carries the invoiced amounts of good or services provided by the vendor after receipt of the checks. The "Preference" column reflects the vendor's preference exposure between cycles of new value.

While not illustrated in the table, to the extent the value of the subsequent advance exceeds the amount of the preference, the surplus new value cannot be used to offset later preferences. For instance, if the subsequent advance had been an amount greater than the January 1 preference (e.g., a $15,000 subsequent advance), the surplus value could not be used to offset any amount of the January 30 preference. However, where the vendor seeks to offset surplus new value (that amount in excess of the immediately preceding preference) against the outstanding balance of prior preferences, the trend of courts is to permit such offset. For example, if the subsequent advance of $20,000 used to offset the January 30 preference had been a greater amount (e.g., a $25,000 subsequent advance), the surplus value could be used to offset the outstanding balance of prior preferences.

Where the subsequent value is less than the preceding preference, the preference surplus is carried forward and added to future preferences. Under the emerging viewpoint analysis, the vendor may offset preferences with subsequent advances of new value. The preferences may be carried forward by the vendor until exhausted by subsequent advances of new value. Under this view, the vendor has a subsequent defense based on goods shipped that protects all of the debtor's transfers to the vendor.

Under the analysis employed by a majority of courts, however, the debtor could use the

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WorldCom management, vendors were likewise defrauded. Using SOA, the government is now giving shareholders (and bondholders) a distribution that otherwise could be distributed to vendors who are higher on the priority scheme. The SOA operates outside of the Bankruptcy Code.

The SEC is on a mission to protect the ordinary shareholder and is using SOA for the benefit of shareholders, to the detriment of vendors, where the insolvent customer has issued fraudulent financial statements. One of the risks for vendors as the SEC now champions the shareholder and bondholder is that shareholders may now raise arguments in Chapter 11 proceedings that the preferred treatment they received in Worldcom and Enron should happen in their case. More troubling is that in Worldcom and Enron, as well as virtually all financial fraud cases, investors take risk when they purchase stocks.

Likewise, vendors take risk when they extend credit. Vendors, like shareholders and bondholders, were defrauded by Worlcom and Enron management. In other words, the SEC proposes to transfer hundreds of millions of dollars from one innocent party, creditors and vendors, to another innocent party, shareholders and creditors. Shareholders and bondholders should not be extended a safety net through the SEC's prosecution of SOA, and upend the priority scheme established by Congress with the bankruptcy laws. A credit professional is well aware of the importance of due diligence and credit analysis to reduce the risk of delinquent accounts. Likewise, the shareholder and bondholder should be investigating before investing. The SEC's action merely allows shareholders and bondholders to investigate less.

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-tion. Thereafter, Artmark filed a motion for imposition of sanctions against attorneys for the debtor seeking payment of Artmark's attorney's fees and costs of $99,511.39.

Under Bankruptcy Rule 9011, the signature of an attorney constitutes a certificate that the attorney has read the document, and that to the best of the attorney's knowledge, information, and belief formed after reasonable inquiry, the document is well grounded in fact and warranted by existing law or a good faith argument for the extension or reversal of existing law.

Artmark argued that the debtor's counsel failed to investigate whether affirmative defenses were available to prevent recovery of what otherwise would constitute a *prima facie* preferential transfer. Artmark asserted that because the affirmative defenses to preference actions are contained in the bankruptcy code itself, the pre-filing duty of investigation by a plaintiff as to affirmative defenses is no different that that required for the *prima facie* case.

The *Berger* court found that requiring a plaintiff to anticipate affirmative defenses to avoid Bankruptcy Rule 9011 sanctions reorders traditional burdens of pleading, and denied Artmark's motion for sanctions. The court did not go so far as to say that no pre-filing investigation of affirmative defenses is necessary. Instead, the court found that any duty of pre-filing inquiry is contingent upon the circumstances of the case. As part of its decision, the court did leave open the possibility of sanctions for an obvious defense to a preference action that needs no discovery to establish, such as a statute of limitations defense. But unfortunately, the *Berger* decision leaves little solace for the creditor faced with the possibility of protracted litigation relating to the ordinary course of business defense, and underscores the importance of careful consideration of litigation costs when analyzing prospects for settlement.

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preference transfers twice to enrich the estate at the vendor's expense. First, the debtor could use the preference payments to offset the subsequent advances of $100,000. The debtor would then seek to recover $70,000 as preferential transfers. The subsequent advance following the March 15 transfer could be used to offset the March 15 transfer as it remains unpaid. The vendor would have to file a proof of claim for $70,000. The majority rule penalizes the creditor for precisely what the policy objectives supporting the subsequent advance rule seek to advance – vendors supplying goods and extending credit to financially troubled debtors during the preference period. Under the majority rule, vendors will not supply troubled debtors because, as demonstrated in the sample calculation, the debtor ends up in a better position as a result of the preferences and subsequent advances, whereas the vendor is worse off.

Moreover, in open account relationships, often the creditor conditions subsequent advances on the debtor's payment of a preceding shipment. For example, if the vendor had refused to supply the debtor with additional goods, unless the debtor paid for the initial shipment, the vendor is saying it will risk no more than $10,000 on this debtor.

However, applying the majority rule, the vendor ends up losing the amount subject to recapture by the trustee as well as the value of its subsequent advances. Indeed, if the vendor had stopped shipping to the debtor after the initial $10,000 shipment, the debtor would not have received new merchandise worth $90,000. The value of these shipments to the troubled debtor exceeds the payments made by the debtor.

What It Means To The Credit Professional

The analysis employed by those courts adopting the emerging viewpoint better meets the legislative objective of encouraging vendor support to financially strapped debtors which may permit debtors a further chance to solve their problems and possibly avoid the need of bankruptcy, while discouraging creditors from racing to the courthouse, because subsequent advances will not be penalized.

The majority rule's interpretation of the subsequent advance rule, which is unsupported by the statues' language, undercuts this policy. Courts adopting the majority rule create a situation where a creditor extending further credit in reliance on prior payments faces an increased bankruptcy loss. The effect of his rule is that a vendor dealing with a debtor on open account will be unlikely to continue to deal with the debtor if virtually all of the debtor's payments are recoverable as preferences notwithstanding further shipments given by the vendor.

The emerging viewpoint also better recognizes the commercial realities of the debtor-vendor relationship. In deciding whether to furnish additional credit, a vendor does not look to one isolated transaction but rather the debtor's entire repayment history. Because the estate has been enhanced by the subsequent advance, the vendor and the estate are in the same position as if the preference had not been made. However, where the subsequent advance is paid for with an otherwise unavoidable transfer or the vendor has retained an unavoidable security interest in a subsequent advance, no replenishment has occurred and the subsequent advance rule should be unavailable.

FRAUD: "WHEN THE UNBELIEVABLE HAPPENS"

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products or services. Fraud occurs when the perpetrator intentionally misleads the offended party into a false sense of confidence. (i.e. "con") Once a fraud is discovered, it is typically of great surprise to the victim. It is typically the employee you least expect or a company you trust. As a result there is lax adherence to the processes and controls that can effectively deter fraud. The door is open.

Even more alarming is the extent that fraud may occur under our nose and it is not discovered. For example, does your company have appropriate internal controls? When a debtor files for bankruptcy protection do you pursue the debt through the bankruptcy process or, is your company writing off balances where deliberate fraud may have occurred? Does your company pursue small balances or, do you have a threshold under which you just write-off the balance, with no efforts to collect? These policies may seem like the most practical approach to an overworked and understaffed organization, but are they inviting the opportunity for your company to become a victim?

Aside from check, or credit card fraud, there are three categories of fraud of premier importance to the credit professional:

- **Organizational identity theft:** The perpetrator assumes the identity of a legitimate company.

- **A "Shell" Company:** A shell company may have a website, sophisticated promotional materials, be registered as a business, have a telephone listing with directory assistance, provide fake bank and trade references and can be found on credit reports based on false information they provide. Once they have established credit with the victim company and receive product, they close their doors and disappear, bills unpaid.

- **"Bust Out":** The perpetrators seek to establish a significant credit relationship with victim companies. They may either acquire a company with a good reputation or start a new company. A target could be a family business being sold after the retirement or death of the long term owner. The product line changes to goods that are easily sold. This has been made easier in recent years with the coming of on-line auction services. Products sold may have no relation to the traditional business of the company or its name.

Months may go by. Product is ordered, bills are paid. Then a large order is placed, shipped and billed. You guessed it, the debtor disappears.

How do Seemingly Honorable People Commit Fraud and Get Away With It?

The **"Three E's": Error, Ego and Economics** give insight into how fraud is allowed to happen. What motivates an individual to commit a fraudulent act, even if, from an outward appearance, it seems unlikely they would do so?

Errors Enabling Fraud

To "Error" is human. People in business make mistakes. Decision making is about choosing among alternatives and taking risks. In today's fast paced environment choices have to be made rapidly, sometimes with minimal time for research and thought. The credit decision making process can either prevent or open up the possibility of fraud.

Credit professionals today have a serious dilemma. On the one hand there is tremendous pressure to help our companies build market share and increase revenues. On the other hand, we must manage reasonable risk with minimal staff and resources.

Fraud is facilitated by the perpetrator's knowledge of these pressures. They also know many creditors are not trained to recognize the danger signs for fraud.

In today's competitive environment, credit decisions commonly focus on three elements: the financial viability of a debtor, the documentation provided and the projected revenue stream expected from sales to the debtor. The fraud victim may not take the time or have adequate processes to confirm either the accuracy of the information provided, or the honesty of the debtor. This opens the door for a fraudulent debtor to alter information sufficiently to secure credit approval. Unfortunately credit professionals must maintain a healthy degree of skepticism toward a new or problematic customer and any information they provide.

An honest mistake is one thing. However an ill informed mistake could cost you your credibility and even your job. It is more important than ever to be honest, with yourself and your company, about what you do and don't know. It doesn't pay to make assumptions and make uninformed decisions.

Employ the information and resources needed to rapidly keep you informed. It all starts with knowing your customer.

- The Credit Application is a critical first step. An effective Credit Application can help in all potential stages of the creditor/debtor relationship:
  - During the "pre-approval stage as the credit relationship is being defined.
  - On an ongoing basis when terms are extended to the debtor, the credit relationship grows and a review is needed.
  - As problems arise between the debtor and creditor
  - ◊ As a useful tool in the litigation process.

- Utilize trade databases and web-based credit reporting sites. Review the history and trade experience closely. Confirm the company is reporting details about itself accurately. Watch for alerts concerning changes in business structure or payment practices.

- Participate in trade credit groups such as those sponsored by NACM Affiliates. Trade groups provide access to other creditors selling to your customer base. You will get timely information to clear new accounts and keep current on debtor payment practices. Your "credit professional" peers can also provide advice, comparative approaches and best practices.

- Utilize the NACM's Asset Protection Group. (APG) The available database provides a continuously updated list of companies or principals with a fraud history. APG is staffed by professionals with experience in law enforcement and business fraud investigations. They work with federal and local law enforcement and participating NACM members representing a broad spectrum of the business world and in many industries.

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FRAUD: "WHEN THE UNBELIEVABLE HAPPENS"

(Continued from page 7)

- When there is a material risk, review debtor financial statements.
- Have someone in your company visit the customer's place of business before the first shipment. If it is practical this should be someone from the credit department.
- Be on top of collections. Regularly contact the debtor and ensure that payment terms are adhered to. Conduct periodic customer visits to larger or problem accounts.

Do not let inadvertent errors enable a fraud perpetrator to victimize your company.

The second "E" is "Ego"

An inflated Ego can blind us from the facts and consequences of our actions. "Ego" oriented decisions are relevant to credit professionals from two perspectives.

Don't let your ego get in the way of a tough decision. It is a changing world out there. Realize the facts may change surrounding a past position you have taken on an issue. Circumstances may have changed for a debtor company you previously supported. Step up to the facts at hand and do the right thing.

Also, watch out for principals of customer companies who let their "Ego" get in the way. The executives now being tried and convicted for their misdeeds are poster children for this one.

I once sold to a medium sized distribution company with an owner who felt he had the magic touch. After some successes he started buying smaller competitors with borrowed money. He felt he could do no wrong. Well, the obvious happened. He made some bad choices, couldn't meet his obligations and filed Chapter 7. The proceedings uncovered some less than legal activities during the last months prior to the filing. His decisions were blinded by his "Ego".

The third motivator is "Economics"

The desire for personal gain along with a blinding ego is a great formula for deceptive business practices and fraud. WC Fields once said, "A rich man is nothing but a poor man with money." Don't let someone in expensive clothes, an elaborate office, or a seemingly prestigious company deceive or intimidate you.

Unfortunately, the recent conviction of Martha Stewart and other top executives is an example of a growing problem in business today. Business fraud is something all of us will face at some time in our career. It could manifest itself as check or credit card fraud, a misstatement of a company's financial status, a break out operation, a catastrophic embezzlement by a trusted employee or in many other forms. We have to be constantly on the look out and aware of when a fraud is a possibility.

The Triangle of Fraud

The "Triangle of Fraud" helps explain how a fraud friendly environment can exist. What factors, in combination, act as an incubator for fraud either from within a company or from outside.

On one side of the triangle is "Pressure":

- This can be economic pressure, an individual or company has desperate financial problems. A sole proprietor or partner has everything invested and everything to lose.
- An individual is living way beyond their means; they or a family member has severe health problems, a substance abuse issue or gambling debts.
- Employees may feel pressure related to their workplace. They don't get along with their manager, they were passed up for promotion or didn't get a raise. For any number of reasons there may be a desire to get even.

Oftentimes the pressure is perceived by the perpetrator and is not apparent to the outsider. Pressure can motivate, even apparently honest people, to commit fraud.

The second side of the triangle is "Rationalization":

- "My company is small and I am defrauding a large company. Anything I get from them will be immaterial."
- "I will just do this once and never again", or "just once more and never again."
- "The company owes it to me"
- "I will pay it back"
- "I am only doing to them what they are doing to me"
- "I am doing it for a good purpose so I don't feel guilty"

"Opportunity" the Third Side:

For fraud to be successful, "Pressure" and"Rationalization" must rest on a base of "Opportunity". There is "Opportunity" for fraud and deception when:

- The company has lax controls with no checks and balances.
- Credit and collection policies are based on a belief the "unbelievable" will never happen.
- Decision makers are apathetic.
- Staff has poor training in the danger signs of fraud
- The desire for new business, or to retain business, takes priority over sensible controls and business practices.
- A perception by the perpetrator that he or she can get away with it.
- When perpetrators are better informed on the victim's policies, and processes and the gaps, than the victim.
- The environment is "too trusting", there are no audit trails, follow-up is lax
- It is known that the victim never pursues a debtor owing below a given balance.

To some degree these three sides of the "Fraud Triangle" pressure, rationalization and opportunity balance one another. The higher the pressure the less rationalization and opportunity is needed to commit fraud. Professional criminals are dishonest and require less rationalization to seize the "opportunity" if they perceive it is available.

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FRAUD: "WHEN THE UNBELIEVABLE HAPPENS"

(Continued from page 8)

So What Can be Done to Prevent Fraud?

All good credit professionals know that credit decisions are made with some intellect and a lot of "gut feeling". If something does not seem right or is inconsistent it probably is. Seasoned credit professionals get an intuitive sense. To help the process along, go back to basics. Remember the **"Four C's of Credit"?** Think of these in the context of fraud prevention:

- **Character:** Understand and verify the standing of the company. What is the employment history and background of the principals and key executives? Use independent sources of information.
    - Are there unexplained time gaps in the employment history?
    - Get phone numbers and addresses of previous employers. You may want to order a credit report on a previous company as well.
    - Have they been involved with companies having history of bankruptcy or any other derogatory activity?
    - If you are suspicious of a new debtor requesting a large credit exposure, ask for the principal's supervisor or other high level contact at a previous company.
    - Can you verify business registrations with the appropriate agencies?
    - Has the company recently made a name change or a major product switch?
- **Capacity:**
    - ◊ Can you confirm the company has sufficient assets, financial structure and a reasonable business model to meet its future obligations?
    - ◊ Confirm bank and trade references. Are the references unfamiliar? Do they have a name that does not fit, "Global", "International" etc.? If you are unsure of a trade reference, call local information and confirm the address and telephone number. Many frauds are based on fake references set up by sophisticated organized crime elements. Be sure you make contact with the questionable reference at the number you have confirmed. Avoid answering services and cell phones. Question a mail service or Post Office Box as a business address.
    - Does the company have a track record selling products similar to yours?
    - ◊ Do the principal's and executives have the education and experience commensurate to their position and the industry? Sometimes the real owner would never pass a cursory background check. The owner listed is merely a "front". The two warning signs to look for are: inadequate experience to go with their title, and no connection to the company's industry.
    - ◊ Check the corporate ownership structure. Is the subject company part of a confusing or unverifiable corporate family tree?
- **Collateral:**
    - ◊ What type of security are you able to obtain as protection from credit exposure?
    - ◊ How liquid will your claim be? UCC1? Personal Guarantees? Commercial or Standby Letter of Credit? Or…… nothing?
    - ◊ Confirm any collateral pledged exists. Be sure liens are perfected.
- **Conditions:**
    - What is the nature of the product the debtor is buying? Perishable? Easily sold on the open market? Requires no reconfiguration prior to being sold by the debtor?
    - ◊ What is the demand for the product sold? Is the volume ordered excessive for the debtor's business, region or season?

Conclusion:

Fraud takes many forms. It can come from within your company as well as from customers. Awareness is the key to not becoming a victim.

Internally, look out for employees who may be under personal pressure, especially when combined with bad feelings towards the company.

Know your customers. Constantly look for fraud danger signals such as:

- Unsolicited Orders
- Rush Orders (maybe at a trade show)
- Phony references
- An abnormal number of trade credit inquiries on a customer. Particularly look out for a high number of inquiries on a customer recently approved, perhaps for a modest line of credit. Save all inquiries for future reference.
- The background of principals is uncertain.
- The source of capital is not clear
- Recent change in ownership, particularly if combined with a change in product lines.
- A name similar to another well established business or a name that does not fit the size and mission of the company.
- Sudden increase in demand
- Evasive or can not be reached other than by voicemail, always wants to call you back.

Have well defined controls, checks and balances and procedures in place and consistently adhere to them. Utilize the vast array of information resources, networking and trade interchange opportunities available.

Above all use your instincts. Maintain a healthy skepticism when reviewing new account applications or requests for credit increases. As cynical as it sounds, there is a twist to the Ronald Regan quote from the cold war years that applies….. Don't trust and verify.

Robert S. Schultz is a partner in Quote to Cash Process Consulting and Chairman of the Board of CMA.

THE CREDIT DEPARTMENT, THE SALES FORCE AND SARBANES OXLEY: A UNIQUE RELATIONSHIP THAT MAY BE SCRUTINIZED IN LIGHT OF RECENT FEDERAL LAW

(Continued from page 3)

-ng, is estimated to have cost the economy $200 billion.

SOA requires more accurate financial disclosure and reporting from public companies. SOA has earmarked over $700 million for the Securities and Exchange Commission to investigate and prosecute corporate fraud. The Justice Department and SEC are pursuing corporate fraud charges with zeal.

Prosecutors are not only targeting senior executives who have reaped millions through their corporate misdeeds, but are moving down the chain of command. Prosecutors are indicting lower level employees allegedly enmeshed in the fraudulent reporting. SOA does not distinguish between accounting, finance and sales functions as they relate to revenue recognition. Criminal prosecution for violating SOA may cut across all revenue recognition functions, from sales to finance to credit.

There are reports of companies restating their earnings in the millions because of the company's sales practices, including undisclosed side agreements by the sales force and customers. For example, it is reported that U.S. Foodservice inflated revenues through promotional rebates from its suppliers. Salespersons purportedly gave false information regarding promotional allowances that resulted in overstating revenues. Government investigations are being pursued.

In light of SOA, concerns regarding certain types of undisclosed sales practices, and the sales force working closer with the credit department, what concerns does the credit professional have in this relationship?

The Interplay Of The Sales Force And The Credit Department

The sales force is a valuable resource of credit information and should be readily tapped during the credit analysis. Frequent contact with sales personnel should promote the exchange of information and close coordination of action regarding the customer. Participation in sales meetings is essential to clarify the role and responsibility of credit, especially in how credit will deal with customers. Additionally, sales is a major source of information regarding the resolution of payment disputes.

One of the major contributions of the credit professional to the selling function is to work with customer and sales persons to seek ways to do more business. For example, a credit executive may be able to suggest a financing method not previously considered by the customer, or may be helpful in locating sources of capital for a customer's upcoming selling program.

The Credit Department And Sarbanes Oxley

SOA was adopted to combat the wave of fraudulent accounting and financial reporting scandals and corporate bankruptcies. SOA focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. SOA imposes a number of duties and restrictions on officers and management of publicly traded companies. The CEO and CFO must sign a certification that the company's periodic reports, 10-Q and 10-K reports do not contain untrue statements. All financial information must accurately present the company's financial conditions and results of operation for the period.

SOA provides that the SEC enforces the legislation and has earmarked $766 million for SEC enforcement. The crime of financial fraud is added and the statute of limitations to bring such action is five years. Mail and wire fraud penalties are increased to 20 years.

A credit professional often has responsibility over managing, accounting for and reporting significant assets and liabilities of the company. Those responsibilities include managing an accounts receivable portfolio valued often in the millions or hundreds of millions of dollars. The aging and collectability of the accounts receivable may have a significant impact on a company's financial reporting to the public markets. A company's DSO is also an important indicator of the quality of the company's accounts receivable, and therefore asset quality. The calculation of a DSO may be influenced. The amount of bad debt reserves can be an important measurement for a company's accounts receivable.

As all of these calculations impact revenue recognition, they can trigger an SEC investigation if earning must be restated. Given this, the credit professional must be concerned with SOA. And the credit professional's relationship with the sales department must also be examined in the context of SOA.

The Sales Force, The Credit Department And Sarbanes Oxley

SOA may be triggered with sales where the salesperson makes side deals with customers, such as hidden discounts. These hidden discounts are not found in the basic contract or vendor agreement, and are not communicated to the finance department. These ancillary agreements result in a distort picture of a company's revenues. These hidden discounts, once disclosed, may add up to a significant impact on a company's revenues, and may force the company to restate its earnings. A company restating earnings is a red flag for SEC investigation under SOA.

In light of this, the credit department, given its closeness in working with the sales force, may question sales practices, or at least raise flags about sales practices that may be considered suspect. Compensation is the driving force for the salesperson to craft a side agreement to a sale's contract. The sales force is generally compensated based on sales generated. This creates pressure on the sales force to reach number

Upstream certification has been discussed in this publication as it applies to the credit professional. See: "SARBANES-OXLEY ACT & UPSTREAM CERTIFICATION: TYING THE CREDIT PROFESSIONAL TO ACCURACY OF FINANCIAL STATEMENTS." As with upstream certification and the credit professional, it may be appropriate for the sales force to sign comparable certifications that there is no side deals with their sales contracts.

The salesperson may also be asked to sign a code of ethics. The ethics statement may set forth what is acceptable sales practices.

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HOW ARE THE BANKRUPTCY COURTS TREATING RECLAMATION: A RECENT REVIEW

(Continued from page 3)

bank's] secured claim was paid. . .all of the goods or proceeds of those goods were disposed of to 'pay' [the bank's] secured claim." Consequently, the proceeds of a sale of the reclaimed goods were effectively "paid" to the secured creditor, and the vendor's reclamation claims were valueless.

This case illustrates that vendors must be mindful that their reclamation claims will not survive the rights of a prior secured creditor with a floating lien on the debtor's inventory or a where a debtor sales the goods to a good faith purchaser prior to the reclamation demand. If a vendor's reclamation claim is found to be valueless, the bankruptcy court does not have the authority to grant priority or a replacement lien. Hence, the vendor will be left with a general unsecured claim. The main thing to remember is that if the debtor has a lender who is undersecured, you may lose your reclamation rights.

Vendors should also note that return of the goods is the preferred remedy, as an administrative claim or lien may be worthless if the secured creditors' claims amount to the entire value of the goods.

EXHIBIT "A"

BANKRUPTCY RECLAMATION DEMAND LETTER

[*date*]

VIA FACSIMILE AND OVERNIGHT MAIL *[OR, HAND DELIVERY]*

[*Debtor*]

Re: [*Debtor's Case Name*]

Dear [*Debtor's Officer*]:

This letter constitutes a notice of demand for the return of certain goods purchased by the above-captioned debtor ("Debtor") from [*Creditor*] (the "Seller"). Please take notice that pursuant to [*State*] Commercial Code 2702, 11 U.S.C. section 546(c), and by virtue of the Debtor's insolvency, the Seller hereby demands the segregation and return of all the *[Reference goods]* (the "Goods") currently in your possession and delivered to you on or after [*Delivery Date*] pursuant to the invoices, dated [*Invoice Date and Invoices Numbers. Invoices may be attached*]. Unless you authorize the return of the Goods immediately, further appropriate measures will be taken.

Please contact the undersigned immediately to make arrangements to allow the Seller to reclaim the Goods. I look forward to hearing from you shortly.

Sincerely,

[*Credit Executive*]

THE CREDIT DEPARTMENT, THE SALES FORCE AND SARBANES OXLEY: A UNIQUE RELATIONSHIP THAT MAY BE SCRUTINIZED IN LIGHT OF RECENT FEDERAL LAW

(Continued from page 10)

Conclusion

The SOA may force publicly traded companies to report their financial information more responsibly, emphasizing full disclosure at both the sales and credit level. Ambiguous sales policies, especially where they involve the credit department can no longer be tolerated in face of SOA. There are significant penalties for those who choose not to adequately disclose or fraudulently disclose. Given the SEC's interest in pursuing questionable corporate reporting, including restatements of earnings, the credit professional must be especially mindful of the financial information being reported, especially as they work ever closer with the sales force.

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Spring 2004

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 ***National Electrical Distributors Group*** regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to ***NACM/MidAtlantic*** regarding ***Article 9 of the Uniform Commercial Code.***

◊ Scott spoke to the ***NACM/Connecticut Fine Paper and Newsprint Group*** regarding ***Creditors' Rights and Bankruptcy.***

◊ Scott spoke to the ***National Group Management's Confection Group*** in San Diego regarding ***Hot Legal Topics for 2003.***

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

◊ Scott spoke to the ***NACM/Louisville's Speciality Chemical Group*** in San Diego regarding ***Bankruptcy and Creditors' Rights***.

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

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

◊ Scott spoke to ***CMA/Computer Industry Credit Group*** regarding ***Credit Applications***: ***Recent Developments***.

◊ Scott spoke to ***NACM/Florida's Computer Industry Group*** in San Jose regarding ***Creditors' Rights***.

◊ Scott spoke to ***NACM/Florida's credit group*** in San Diego regarding ***Pre-Sale of Goods Legal Issues.***

◊ Scott spoke to ***Staffing Services Credit Group*** regarding ***Creditors' Rights.***

◊ Scott spoke to ***Reimer Reporting's Outdoor Products Group*** in Las Vegas regarding ***Involuntary Bankruptcy Petitions***.

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