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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

THE CRITICAL VENDOR DOCTRINE AFTER KMART:

CAN YOU STILL GET PAID NOW, IN FULL, ON YOUR BANKRUPTCY CUSTOMER'S ACCOUNT?

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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; and worse, the payment is usually but a fraction of the claim. Furthermore, it is not uncommon for the creditor to receive stock in the reorganized debtor in exchange for its prepetition claim (as was the case in the Kmart Chapter 11). Traditionally, the creditor would file a proof of claim, perhaps serve on the creditors' committee and press for a meaningful payment on their prepetition claim. Does a creditor in this situation, especially one with a substantial trade relationship, have any recourse? *With the development of the critical vendor doctrine, the credit professional has had a meaningful alternative.*

On occasion a vendor may be a key supplier to a customer that files Chapter 11. Given this key supplier relationship, the creditor often holds a sizeable unsecured claim upon the Chapter 11 filing. The creditor, selling invoice by invoice (as opposed to a long term supply contract), may elect not to continue to sell the debtor postpetition. However, the creditor's product or service may be viewed by the debtor as essential to its continued operations, such as when the debtor cannot locate a substitute vendor. Without the product or service, the debtor may be forced to close, which, contrary to the principle of bankruptcy, may further harm the non-critical vendors. In this situation the debtor may request that the bankruptcy court authorize it to immediately pay a critical creditor's prepetition claim, in exchange for that critical vendor selling to the debtor post-bankruptcy on credit.

More and more bankruptcy courts throughout the country have been considering a debtor's request to treat certain vendors as critical, and have their prebankruptcy claims paid in exchange for postpetition trade credit. However, as a result of the Kmart ruling, the support of bankruptcy courts for critical vendor requests may change.

In the Kmart case, the Seventh Circuit Court of Appeals affirmed the district court's reversal of the bankruptcy court's authorization for critical vendor payments. The Supreme Court declined to hear the appeal from the Seventh Circuit. This raises the question:

- What is the impact of the Kmart ruling on the critical vendor doctrine?
- Does the critical vendor doctrine survive?
- If so, with which courts; and what

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CHARTING THE CHANGES ON THE BANKRUPTCY PREFERENCE HORIZON

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The winds of change from Congress seem to be having an effect on the preference horizon, even before enactment of the new preference laws. In the recent decision rendered in the case of U.S. Interactive in the District of Delaware, Chief Judge Mary F. Walrath determined that due to the debtors' and creditor's short-term history, the creditor was required to prove a definite industry standard. Judge Walrath's decision is a precursor of the changes ahead under the proposed preference revisions.

Under current bankruptcy law, all payments made by a debtor to creditors within 90 days of a bankruptcy filing must be returned to the debtor's estate, unless the creditor can prove that the payment was made in the ordinary course of business or subject to another available defense. The ordinary course of business defense currently includes three elements. The first element, which is rarely contested, is whether the transfer was in payment of a debt incurred by the debtor in the ordinary course of business of the debtor and the transferee. The second element, the subjective standard, requires that the transfer was made in the ordinary course of business of the debtor and the creditor. The third element, the objective standard, requires that the transfer was made within the industry standard.

The Senate has approved the Bankruptcy Abuse Prevention and Consumer

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SUBCONTRACTORS AND MATERIALMEN: KNOW YOUR RIGHTS!

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Subcontractors and materialmen are afforded numerous protections when shipping to a questionable contractor, or any contractor for that matter. As a subcontractor or materialman it is important that you are aware of these protections and how they protect your investment of labor and/or product. This article will provide a brief summary of the available protections, including mechanics' liens, stop notices, statutory trusts, contractual trusts, and joint checks.

Mechanics' Lien

The mechanics' lien is a lien created by statute for the purpose of securing priority of payment for the price of the value of work performed and materials furnished in construction or repair of improvements to land. The lien attaches to the land as well as the improvements. Essentially, the mechanics' lien is a powerful tool that provides special protection to those who labor to improve the property of others.

Generally, to be eligible for a mechanics' lien, the claimant must (1) provide labor and/or materials to the project; (2) the labor or materials must be consumed in the project; and (3) the owner or the general contractor must authorize the services or materials. More specifically, the claimant will need to (1) serve a preliminary 20 day notice, (2) record the mechanics' lien, and (3) file a lawsuit to foreclose on the lien. Generally, the lien may not be recorded until the claimant has finished furnishing labor and/or materials to the project.

Although recording the mechanics' lien is often the most important element, it is critical that the lien notice requirements are complied with. The preliminary notice notifies owners of potential lien claims against their property. A defective notice may result in the loss of mechanics' lien or stop notice rights.

Stop Notice

A stop notice provides notice to a lender or owner that a subcontractor or materialman has not been paid. Unless a bond is posted to cover the unpaid balance, the lender must withhold moneys due the general contractor. The stop notice gives the claimant a lien against undisbursed construction funds in the possession of the owner or the lender. Generally, the mechanics' lien and stop notice may be utilized simultaneously along with a lawsuit for breach of contract on the underlying debt.

The same eligibility requirements for the mechanics' lien apply to the stop notice. In addition, the claimant will need to (1) serve the stop notice, (2) record the stop notice, and (3) file a lawsuit to enforce the stop notice.

Unfortunately, mechanics' lien and stop notice laws are very technical and require the proper steps to be taken to assure that the remedies will not be lost. In the event that the remedies are lost, the subcontractor or materialman may still commence a lawsuit for breach of contract to recover the underlying debt.

Statutory Trust

Some state legislatures have established construction trust statutes that provide additional protection to subcontractors and materialmen (e.g., Colorado, Delaware,

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FROM THE PUBLISHER:

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Guest Column

IN-HOUSE COUNSEL: A "GLASS CEILING" FOR CREDIT MANAGERS?

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Many companies start their existence with the assistance of outside counsel – there is simply not enough legal work to justify the expense of hiring in-house counsel.

However, as the company grows over the years, it gets to a "critical mass" where the legal work is now well into six figures, and the decision is made to hire the company's first inside counsel.

Consider the following possible scenario.

Company A has grown rapidly by acquiring complementary products lines; each of which functions somewhat autonomously under its traditional name. However, visibility in the marketplace is a problem, and new executive management decides that a major image makeover is needed.

The company adopts a single name, and new in-house counsel is hired in-part to change all of the company registrations and records in all of the states where the company does business; as well as all other legal matters.

In order to gauge the cost-savings realized by employing in-house counsel, executive management might direct all of the divisions to compile a history of legal fees paid to outside counsel for the past few years; including name, address, and rationale for hiring the firm. Division managers would then be advised that all legal arrangements must be approved in advance by in-house counsel; as would be all subsequent legal fees.

Letters could then be sent out to all of the outside firms advising the firms that new in-house counsel has been hired, and that the outside firms may no longer bill fees unless at the direction of in-house counsel.

Many in-house counselors are generalists and/or have specialties other than what credit managers refer to as "creditors rights." In

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JUST THE FACTS ABOUT THE FACT ACT: WHAT DOES IT MEAN TO THE CREDIT PROFESSIONAL ?

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The Fair and Accurate Credit Transaction Act of 2003, or commonly referred to as the Fact Act, amended the Fair Credit Reporting Act. The Fact Act was signed into law by President Bush on December 4, 2003.

The Fact Act is primarily aimed at providing consumers with more options to protect and monitor their credit. The Fact Act may spill over to businesses obtaining and using consumer credit reports. We examine how the Fact Act amends the Fair Credit Reporting Act, and how this may impact the credit professional.

Overview of the Fact Act

The Fact Act was passed because consumer reporting agencies have assumed a vital role in assembling and evaluating consumer credit information. Congress recognized a need to make sure that consumer reporting agencies exercise their responsibilities with fairness, impartiality, and respect a consumer's right to privacy by safeguarding private financial information.

The Fact Act Amends the Fair Credit Reporting Act

In 1996, the Fair Credit Reporting Act was amended. These amendments provided new consumer rights, but under these amendments, states were temporarily preempted from passing stronger protections in specific areas. The Fact act permanently reauthorizes the seven national uniformity provisions of the Fair Credit Reporting Act (FCRA) that were scheduled to expire on January 1, 2004.

The seven national uniformity provisions prevent states from creating conflicting legislation concerning the sharing of credit information, credit bureau reports, application information, and transaction and experience data.

Creating national uniformity in these areas allows business to have clear guidelines when using credit information and reporting fraud related to private financial information. Businesses should not be required to follow different legislation passed by 50 different states. Even more significant, is that the Fact Act has allowed the federal preemptive uniformity approach into the related arena of identity theft.

Before the enactment of the Fact Act, Congress had only passed one law in response to the growing crime of identity theft. Congress made identity theft a felony and ordered the FTC to coordinate federal efforts to monitor the crime.

Changes the Credit Professional May Anticipate as a Result of the Fact Act

The changes credit professionals experience should be relatively minimal. When extending credit to a sole proprietor, partnership, or when principals execute personal guarantees, obtaining consumer credit reports on the principals is helpful to determine creditworthiness. The FCRA still requires vendors to obtain express written consent from the customer in these circumstances before obtaining a consumer credit report.

The Fact Act does, however, govern how a vendor stores these consumer credit reports, process consumer fraud complaints, and a few other related areas.

Key Provisions of the Fact Act

The Fact Act enables consumers to obtain one free copy of their consumer credit report from certain reporting agencies during a twelve month period. The Fact Act also provides harsh new requirements on companies that trade or use consumer credit information. The Fact Act mandates that vendors and credit agencies improve their systems for dealing with consumer fraud complaints and sensitive information like credit card numbers.

The Fact Act also allows states to have the authority to continue to protect their residents from identity theft. States may pass legislation to supplement the Fact Act identity theft provisions as long the legislation does not upset the preemption mentioned above.

California recently passed SB3186. This legislation requires businesses, conducting business in California, to notify consumers when their private financial in-

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SCRUTINIZE YOUR PREFERENCE SETTLEMENT: ARE YOU GIVING UP YOUR REPLACEMENT CLAIM?

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The credit professional is well aware of the pain that a major customer's Chapter 11 filing brings at the front end of the case, with the unsecured claim for unpaid invoices. But the back end of the customer's Chapter 11 may be even more painful if the credit professional must face a preference demand. Unfortunately for the vendor, preference claims seem now to be a cost of business, and the credit professional needs to be schooled in all facets of the preference action.

Suppose a year after the major customer files Chapter 11, and after the plan of reorganization is confirmed, you receive a preference demand letter from the liquidating trust. The trustee demands that you return all payments received within the 90 days of the customer's bankruptcy filing. Your preference analysis reveals that you have preference exposure based on your weak ordinary course of business defense. Through negotiations with the trust, a sizeable reduction in your preference exposure is made. However, you must pay back to the trust some payments received during the preference period. As part of the negotiations, the trustee insists that you waive your preference replacement claim. With those repayments, are you entitled to an unsecured claim, the so-called Replacement Claim? What is the Replacement Claim valued at? What happens to the recaptured preference payments?

A. The Bankruptcy Preference Law

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 law is intended to discourage vendors from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Debtors are also deterred from preferring certain vendors by the require-

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STOPPING GOODS IN TRANSIT AND RECLAMATION DEMANDS UNDER CHECK 21: DOES THE VENDOR NOW HAVE GREATER PROTECTION WHEN ACCEPTING PAYMENT BY CHECK?

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You conclude that a new customer is too risky to extend terms, so you insist on COD. You authorize shipment on the condition that your delivery driver picks up the check from your customer. The goods are delivered, but several days later the check is returned "NSF." You immediately contact your shipper to stop further deliveries to the debtor, and return any product in transit to your warehouse. You also make a reclamation demand for the goods the debtor recently received.

Unfortunately, the shipper reports that it cannot honor the stop shipment demand as the goods had already been delivered to the debtor. Further, the debtor responds to the reclamation demand by advising that your goods have already been used in the ordinary course of its operations. You rightfully complain that that had you received prompt notice of the "NSF" you could have stopped some shipments reaching the debtor, and perhaps reclaimed that product that reached the debtor.

A new law may be better protect vendors from the too common situation above. On October 28, 2004, a federal law accelerating check processing, known as Check 21, went into effect (the official name, Check Clearing for the 21st Century Act). This is federal legislation affecting all states. Check 21 changes the way that checks are processed in the United States, as well as the technology of check payment and acceptance. Under Check 21, financial institutions are allowed to process checks electronically, instead of transporting the paper.

What is the impact of Check 21 and a vendor's right to stop goods in transit, as well as return goods based on a reclamation demand? Does check 21's "farewell to the float" mean greater protections for the vendor unwittingly accepting payment by check from an insolvent customer?

A. Stopping Goods in Transit

Article 2 of the Uniform Commercial Code deals with the rights of a vendor to stop goods in transit where the goods are in the hands of other bailees, such as a carrier or warehouseman. However, once the goods have been received by the buyer, the right of stoppage is lost.

The vendor may stop goods where the buyer breaches the contract or fails to make payment when due. The vendor gives notice of stopping goods to the buyer with a stop order or stop notice. The notice should be given to the carrier or bailee. Under the UCC, the vendor's right to stoppage is lost upon the buyer's receipt of goods. Receipt is defined under the UCC as physical possession. Stoppage of goods does not consider when title passes.

Courts generally recognize the right of the vendor to stop goods in transit after the buyer has filed bankruptcy. However, the vendor should seek relief from the automatic stay prior to selling the goods. Stopping goods in transit should not be considered a preference, as the buyer did not have an interest in the goods.

The remedy of stopping goods in transit is a time-of-the-essence remedy for the vendor. The vendor must promptly notify the carrier upon learning of the NSF check. Check 21 may better protect the vendor's stoppage rights, as the vendor may be immediately notified by its bank of the NSF, which may permit the vendor to stop the goods that are in transit.

B. Reclamation

Article 2 of the Uniform Commercial Code provides a vendor selling goods on COD the right to reclaim goods when the customer's check is returned NSF. Bankruptcy Code section 546(c) recognizes a vendor's reclamation right where the customer is in bankruptcy and the cash sale was in the ordinary course of business.

A vendor selling goods on cash shortly before the customer's bankruptcy may find the check returned NSF, even with Check 21's accelerated clearing. The vendor should assume that the customer's check will be returned NSF and send its reclamation demand immediately upon learning of the customer's bankruptcy filing.

With Check 21, perhaps the check will clear prior to the customer's bankruptcy filing; however, the reclamation demand may protect the vendor from the risk that the time periods for making a reclamation demand would run out prior to the vendor's receipt of confirmation that the customer's check had been dishonored. Again, due to Check 21, the vendor should receive prompt notification that the check has been dishonored.

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

(i) the vendor sold goods on credit to the debtor in the ordinary course of business of both;

(ii) the vendor delivered the goods to the debtor at a time when the debtor was insolvent;

(iii) the vendor made a written demand for the return of the goods within ten, or in certain cases twenty, days after the goods were delivered to the debtor; and

(iv) the debtor had possession of the goods at the time of the reclamation demand or the goods were not in the hands of a buyer in the ordinary course or a good faith purchaser at the time of demand.

A vendor initiates reclamation by delivering a reclamation letter (*see letter attached*) within ten days, or in certain cases twenty days, after the goods were delivered. The reclamation letter should include a detailed description of the goods in question, a statement of the delivery date to the debtor, and a demand for the immediate return of the goods. The reclamation letter should also demand an accounting. An accounting is crucial, because the right to reclaim may be defeated by the debtor's resale of the goods to a buyer in the ordinary course of business.

If the accounting is not delivered or not accurate, the vendor should be prepared to immediately demand a right to inspect both the inventory on hand and the books and records pertaining to sales of said goods for the period between the date of delivery of the goods and the date of the reclamation letter.

If the buyer files bankruptcy prior to making the reclamation demand (or at any time thereafter) the vendor should promptly contact debtor's counsel in order to stipu-

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is the standard the debtor and critical vendor must establish?

A. History of the Critical Vendor Doctrine

Since the early 1990's, Chapter 11 debtors have asked bankruptcy courts to approve the payment of vendors' prepetition claims that the debtor believes are essential to its ongoing operations. Payment of these claims have been allowed in the interest of enabling a *reorganization that is expected to benefit all creditors*, including those that are not designated as a critical vendor. In some jurisdictions, a motion to authorize payment of critical vendors' prepetition claims has become a routine first day motion in a Chapter 11 case, wherein the debtor articulates its business judgment to support payment of critical vendors.

1. The Equality of Payment Rule for Unsecured Creditors in Bankruptcy

A central principle of the Bankruptcy Code is equality of treatment of unsecured creditors. The equality of treatment rule is embodied, for example, in the preference laws and treatment of creditors' claims under a plan of reorganization. Creditors of the same priority are generally not entitled to be paid on their prepetition claims in Chapter 11, except through a plan of reorganization; and creditors are to be paid the same pro-rata amount on their claims in both Chapter 7 and Chapter 11 cases.

2. Development of the Necessity Doctrine

Notwithstanding the general rule of treating creditors of the same class equally, bankruptcy courts have often relied on the "doctrine of necessity" to allow insolvent debtors to pay vendors whose cooperation is deemed essential to a debtor's continued operations and reorganization. The same doctrine has been routinely invoked to justify payment of prepetition claims such as claims of a debtor's employees for unpaid wages and benefits.

The necessity doctrine was developed in railroad receivership cases of the nineteenth century. Survival of the railroad industry was essential to a large segment of the economy and communities in many regions of the United States, courts were willing to be very flexible in allowing receivers overseeing reorganizations of railroads to exercise remedies necessary for a struggling railroad to survive. These measures included the necessity of payment rule, which allowed payment of certain claims that arose before receivers were appointed. Under this doctrine, claims made by suppliers and other entities essential to railroad operations could be paid ahead of claims that would otherwise have priority, *including claims of secured lenders*.

3. The Necessity Doctrine Outside of Railroad Reorganizations

In the twentieth century, courts began applying the doctrine of necessity to reorganizations of businesses other than railroads, including businesses whose survival was not necessarily linked to the public interest. The doctrine of necessity is believed by its proponents to be incorporated within a bankruptcy court's general equitable powers under section 105(a) of the Bankruptcy Code.

The legislative history of section 105 (a) suggests that this section incorporates equitable powers that bankruptcy courts were previously understood to possess. The United States Supreme Court has stated that it will not read the Bankruptcy Code to erode the past bankruptcy practice absent a clear indication that Congress intended such a departure.

4. The Modern Approach to Critical Vendor Payments

During the past ten years, bankruptcy courts in a number of jurisdictions have been inclined to authorize debtors to pay the prepetition claims of creditors deemed critical, based on a debtor's business judgment. *The concept of "critical vendor" had gone from an extraordinary remedy to something that is simply done as a first day motion filed by debtors in chapter 11 cases.*

However, during the last two years, critical vendor payments have come under increased criticism by some courts, bankruptcy attorneys and scholars. Some critics have noted that there is no provision in the Bankruptcy Code that expressly allows for payment of critical vendors ahead of other creditors. Other critics have maintained that the Bankruptcy Code may allow critical vendor payments, but have argued that this practice has been abused with payments being authorized when a vendor is not truly necessary to a debtor's reorganization. *This criticism culminated in the Kmart appellate rulings.*

B. The Critical Vendor Doctrine

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment to them on their prepetition debt. Often, 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 bankruptcy filing. The payment a "non-critical" vendor receives is but a fraction of the claim owed; or, perhaps, stock in the reorganized debtor.

The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment on their prepetition claim. *The motion also binds the vendor to continue to sell the debtor on terms equal to or better than prepetition terms.* Prior to Kmart, the critical vendor dollar amounts sought were often high. WorldCom, Inc., for example, was authorized to pay vendors up to $70 million. The average relief granted to a mid-sized debtor ranged from $8 million to $25 million. The responsibility to define the vendors who are critical is usually placed in the hands of the debtor. When a company files for bankruptcy, it reviews its list of vendors and uses its business judgment to decide which vendors are critical in order to stay in business.

1. Types of Products or Services that may be Deemed Critical

Below are classes of products and services offered by vendors considered for critical vendor status.

a. Vendors Providing Unique Product

A vendor providing a unique product,

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such as customized tooling, may qualify as a critical vendor. This type of vendor provides some unique part for which there is no immediate substitute vendor for the debtor. The creditor's threat to refuse to continue to provide its unique product creates leverage to be selected as a critical vendor. These vendors fall into the following categories:

Sole Source Vendors: Some vendors may be a debtors' only providers of certain materials or services. There may be no replacement vendors for sole source vendors. Even should competing vendors exist, a debtor may classify certain vendors as sole source vendors where the transition to a new vendor may interrupt a debtor's operations. Where a vendor is the only sole source vendor who readily can provide a debtor with materials or services, it may refuse to continue materials or services due to the prepetition indebtedness, and the debtor's operations could be disrupted while the debtor seeks to locate a substitute vendor, in excess of the amount of sole source suppliers' prepetition claims.

Capacity Vendors: Some vendors of materials may be the only vendors to produce such materials in quantities sufficient to meet a debtor's demands, even though there may be vendors that produce some of the materials.

Quality Vendors: Some vendors may be deemed critical as they are the only vendors that provide the debtor with certain high-quality materials. In some cases a debtor may have customer contracts that require the high quality materials.

Knowledge Vendors: Some vendors may be deemed critical because they have unique knowledge of a debtor's business, or have been responsible for certain aspects of a debtor's business. These vendors have maintained the debtors operations for a period of time and have acquired unique knowledge of the business.

b. Vendors Providing Unique Service

Specialized service vendors are similar to unique product vendors, except that their uniqueness lies in their service instead of their goods.

c. Lack of Competition within Industry

Lack of competition within an industry may give a vendor leverage over the debtor and result in critical status for the vendor. Rather than a unique product or service that a vendor may provide, the mere fact that the vendor lacks competition creates the critical vendor situation.

d. Foreign Vendors

Vendors that provide their product from overseas may create a critical vendor situation. Offshore vendors may find that the debtor cannot find a replacement vendor in a timely manner.

e. Vendors Selling to Companies Subject to Mass Tort Claims

Over the last few years, companies that used or consumed asbestos in their operations (as opposed to manufacturers of asbestos) have been shocked to find themselves the target of mass asbestos litigation and personal injury claims.

This mass asbestos litigation has resulted in at least two-dozen companies filing Chapter 11 to stay this litigation. In the asbestos and mass tort cases, debtors generally have sought critical vendor status for a large portion of its vendor class.

f. Small Vendors

Those vendors whose financial survival is dependent on the debtor paying their prepetition claim have qualified as a critical vendor.

2. 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 with 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. In the trade claims' cap request, the debtor may not disclose those vendors it has selected as critical. If the debtor does dissolve, it may be limited to disclose only to the creditors' committee those vendors it has selected as critical. The debtor uses its business judgment as to which vendor should be deemed critical.

C. Criticism of the Critical Vendor Doctrine

The critical vendor doctrine may be viewed as conflicting with the fundamental principle of bankruptcy, which is equal treatment 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. Other critics argue that courts may have the authority to allow such payments in appropriate cases, but this practice has been over used, which has led to abuses.

Other criticism is that there are very few true critical vendors; rather, the debtor may use the critical vendor motion to favor certain vendors. Thus, these vendors could be substituted with limited harm to the debtor's ongoing operations. Furthermore, if there are indeed true vendors whose product or service is indispensable, those vendors may have economic self-interest to continue to sell especially if the debtor has a vendor lien program or debtor in possession financing in place. These critical vendors may sell to the debtor with or without critical vendor status.

Another criticism is those courts that grant critical vendor motions with a claims' cap, turn the approval of critical vendors over to the debtor, perhaps without creditor oversight.

D. The Kmart Rulings: From the

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Bankruptcy Court to the Supreme Court

Kmart's Chapter 11 was one of the largest filings by a retailer. In an effort to obtain unsecured credit from its vendors and maintain key vendor relationships, Kmart, in the opening days of the bankruptcy, rewarded certain key domestic and foreign vendors with payment on their pre-bankruptcy claims under the critical vendor doctrine. As part of its first-day motions, Kmart filed a motion seeking authority to pay prepetition obligations to its critical vendors. Kmart served its critical vendor motion on about 65 of its key creditors; notwithstanding it had thousands of vendor creditors. Kmart argued these payments were necessary to maintain business relationships with the respective vendors, and the vendors' goods were essential to Kmart's continued operations and a successful reorganization.

1. Bankruptcy court's Authorization to Pay Critical Vendors

Vendors supplying a range of products from food to music to publishing services were paid on their prepetition claims in exchange for these vendors providing post-petition trade credit. The critical vendors agreed to provide credit on customary trade terms for two years. The bankruptcy court authorized payments to the critical vendors totaling $327 million under the "doctrine of necessity" using its equitable powers of section 105 of the Bankruptcy Code. The bankruptcy was satisfied with Kmart's business judgment that without paying vendors their prepetition debt, the vendors would not make shipments postpetition; and without these goods Kmart's reorganization would be threatened.

2. Capital Factors Objection to Paying Critical Vendors

Capital Factors (CF), a company that had factored certain vendors' accounts receivables, held $20 million in claims against Kmart, and was not included among the vendors to be paid pursuant to the critical vendor motion.

CF appealed the bankruptcy court's critical vendor order. CF complained that the bankruptcy court had no legal basis to discriminate paying certain vendors prepetition claims. Under Kmart's plan of reorganization, non-critical vendors received ten cents on the dollar, payable in Kmart stock. *The District court reversed the bankruptcy court.*

3. The District Court Reverses the Bankruptcy court

The district court acknowledged that the bankruptcy court's application of the "doctrine of necessity" was well intended and may even have had some beneficial results. *However, the district court concluded there was no authority under the Bankruptcy Code to afford priority status for the payment of certain prepetition obligations to vendors.*

In reversing the bankruptcy court's decision, the district court determined that such payments were, (1) not authorized by Bankruptcy Code section 105(a)'s broad grant of equitable power; and (2) the critical vendor payments were contrary to the Bankruptcy Code's priority scheme. *The district court rejected the debtor's contention that should the critical vendor order be reversed, it would than have to file thousands of postpetition preference actions to collect the critical vendor payments.* The debtor then appealed to the Seventh Circuit Court of Appeals.

4. Seventh Circuit Court of Appeals Affirms the District Court and Limits the Critical Vendor Doctrine

The Seventh Circuit Court of Appeals affirmed the district court's reversal of the bankruptcy court's approval of the debtor's critical vendor motion. The Seventh Circuit's decision does not flatly reject the critical vendor doctrine, but it does indicate that a debtor seeking authority to pay its critical vendors must be prepared to satisfy heightened procedural and evidentiary standards. The Seventh Circuit noted that the bankruptcy court ruling: "open-ended permission to pay any debt to any vendor it deemed 'critical' in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on 'customary trade terms' for the next two years — was 'in the bests interests of the Debtors, their estates and their creditors'" was overbroad. *In other words, a debtor may not request broad authority to pay critical vendors at its request. Rather, the debtor must identify which vendors are critical.*

The Seventh Circuit found that a court should make a determination that discrimination among unsecured creditors is the only way to facilitate reorganization, and that the disfavored creditors were at least as well off as they would have been had the critical vendor motion not been approved. The bankruptcy court in Kmart addressed neither of these issues. The Seventh Circuit also stated that the non-critical vendors should have received notice of the critical vendor motion, noting that of the thousands of creditors of Kmart, only 65 creditors were noticed.

The Seventh Circuit's decision indicates that a bankruptcy court within this circuit may grant a critical vendor motion pursuant to section 363 of the Bankruptcy Code, provided the four elements (discussed in section 5 below) can be met. The Seventh Circuit has fielded a large share of mega-chapter 11's, such as Kmart and United Airlines, which may require a debtor to reconsider a filing in the Seventh Circuit given the heightened standard.

5. The Supreme Court requests by creditors to consider the Seventh Circuit's ruling in Kmart.

The Seventh Circuit's denial of certiorari (appeal) may create more uncertainty regarding the critical vendor doctrine. In the Seventh Circuit, if a debtor seeks to pay critical vendors, the debtor should seek an order pursuant to Section 363(b)(1) of the Bankruptcy Code.

The debtor must establish:

(1) Such payments are in fact critical to their reorganization;

(2) Discrimination among unsecured creditors is the only way to facilitate a reorganization;

(3) Non-critical vendors will be at least as well off as they would otherwise be if the critical vendor order is not entered;

(4) Such payments will not diminish the amount of funds that ultimately will be available for payment to non-critical vendors. In addition, the Seventh Circuit has

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THE CRITICAL VENDOR DOCTRINE AFTER KMART:

CAN YOU STILL GET PAID NOW, IN FULL, ON YOUR BANKRUPTCY CUSTOMER'S ACCOUNT?

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expressed concerns about notice of a critical vendor motion to non-critical vendors.

A debtor should also provide broader notice of such motion so that non-critical vendors have a better opportunity to respond to such motions. In courts following the Kmart ruling, expect the debtor to be more demanding of vendors in establishing the critical nature of the product or service based on the heightened court scrutiny of critical vendor requests. Also, given the split in the circuit courts, the Kmart ruling may prompt a debtor to consider court venue outside of the Seventh Circuit to file a bankruptcy petition.

6. Kmart's Claw Back (reach back) of Critical Vendor Payments

In light of the reversal of the critical vendor order, Kmart demanded that critical vendors return the critical vendor payments they received. Kmart was forced to sue hundreds of vendors in an attempt to recover these transfers.

E. Special Issues with the Critical Vendor Doctrine

1. Reorganizing versus Liquidating Debtors

As already pointed out, a central element of the critical vendor doctrine is that critical vendors provide an essential product or service that, if provided, will assist the debtor's reorganization. If the debtor is liquidating its assets, the critical vendor doctrine is not met, and such a request should be denied.

2. 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, likely being forced to wait years after the filing.

The debtor files the critical vendor motion with the bankruptcy court. The critical vendor motion usually binds the vendor to continue to sell to the debtor on terms that are equal to or better than prepetition terms. *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, so that it may 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.

a. Proving-Up Your Critical Vendor Status very important information

Although the debtor files the motion with the bankruptcy court to approve critical vendor status, following the Kmart decision the vendor may be expected to provide specifics for the bankruptcy court, as well as creditors, as to why the vendor is so valuable to justify paying its claim ahead of other vendors. To that end, the vendor should review the debtor's motion to pay critical vendors and determine whether the debtor has classified vendors. For example, if the debtor proposes to pay a class of vendors based on their providing a unique product, the vendor should be prepared to provide documents or a statement from a competent witness explaining the uniqueness of the product. Likewise, if the debtor defines a class of vendors as critical based on their knowledge of the debtor's operations, the vendor should be prepared to provide documents or a statement from a competent witness as to this unique relationship.

b. Dealing with the Automatic Stay

The automatic stay is an injunction that automatically and immediately goes into effect upon the bankruptcy filing. It is filed, whether the bankruptcy filing is one under Chapter 7 or 11.

The automatic stay prohibits any creditor from taking action against the property of the estate and against the debtor, unless relief from the stay is obtained. For example, a vendor is barred from seeking or levying writs of attachments or garnishments, and also stays the vendor from a judicial lien against the debtor, but has not yet levied on any property.

The creditor needs to be mindful when requesting critical vendor status that the manner in which the request is made does not violate the automatic stay. To that end, the creditor should consider contacting the customer (debtor) and determine who within the company is responsible for the critical vendor program. Once that contact is identified, the vendor may negotiate with the representative to make the list.

c. Timing of Critical Vendor Request:

✧ ***Prepetition Critical Vendor Request***

A vendor may learn that a debtor is considering filing Chapter 11. To that end, a vendor may approach the customer and request critical vendor status should the customer file Chapter 11. The vendor may request the customer sign a contract recognizing that the vendor would be deemed a critical vendor upon a Chapter 11 filing. Even if the customer signs the contract, there is no assurance that the vendor will be given critical vendor status. Creditors may object and the court ultimately must approve the request.

✧ ***Postpetition Critical Vendor Request***

A debtor usually requests bankruptcy court approval of its critical vendor motion as part of its first day motions. The vendor should request that the debtor select them as a critical vendor. The trend is for the debtor to request critical vendor approval of a claims cap. The debtor does not disclose the vendors it has selected as critical in its motion. Rather, the debtor designates those vendors it deems critical after the court approves the motion.

d. Alternatives to Immediate Payment in Full:

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✧ ***Payments of Less than 100%***

In a claims' cap situation, a debtor may attempt to have its critical vendor dollars go further by offering vendors only a percentage of their prepetition claims paid, for example 70%. There is no legal basis that requires a debtor to pay critical vendors 100% on their prepetition claims.

✧ ***Payments Over Time***

Another alternative a debtor may offer to immediate payment in full of its critical vendors, is to pay those vendors prepetition claims over time, for example over several months. As with the percentage payment, there is no legal basis that requires a debtor to pay the vendors' prepetition claim immediately.

✧ ***Cross-Collateralization Provisions***

A debtor may insist that the critical vendor payments be paid through the vendor's future shipments. In other words, when the vendor ships postpetition, the debtor's payment on the postpetition sale pays down the prepetition debt. The vendor's postpetition debt builds up, which is entitled to administrative priority, and is ultimately paid down after the prepetition debt is paid.

3. Selling to a Chapter 11 Debtor Invoice by Invoice Compared with an Executory Contract

A creditor that has sold a debtor on an order-by-order basis has no continuing obligation to sell the debtor. Because of this, the creditor has leverage on whether to sell the debtor. An element of the debtor's critical vendor request is that the vendor provides a product or service that is indispensable for its continued operations. Should the critical vendor decide not to provide the product or service, the prospects for the debtor's reorganization is diminished. However, with the vendor who is a party to an executory contract, such as a long-term supply contract, the debtor may seek to compel the vendor to comply with the terms of the contract. The automatic stay bars vendors with executory contracts from terminating the supply contract provided the debtor is able to pay for the new purchase orders. Thus, only those vendors selling invoice by invoice should have the leverage to seek critical vendor status.

4. Non-Critical Creditors and Shareholders Viewpoints

a. Unsecured Creditors

A vendor who has not been selected by the debtor to be a critical vendor may oppose the critical vendor motion. The vendor may complain to the bankruptcy court or debtor that it is also willing to provide credit to the debtor postpetition in exchange for payment on its prepetition claim. The reason that the unsecured creditor complains is that the alternative to immediate payment is to often wait years for payment; and only receive but a percentage of the amount owed. Indeed, a debtor may propose that the creditor receive stock in the reorganized debtor on account of the prepetition claim.

With debtors now requesting approval of critical vendor motions without identifying which vendors are critical may take away creditors objections. Where a debtor has requested a claims' cap, the court may approve a pot of money to be paid to critical vendors. The debtor thereafter selects vendors it deems are critical. In this situation, the vendor may be able to negotiate critical vendor standing.

b. Creditors' Committee

In Chapter 11, the creditors' committee comprises the major unsecured creditors of the debtor and is a watchdog for the interests of all unsecured creditors of the debtor.

The creditors' committee, if appointed, may object to the critical vendor proposal, or request changes to amount requested, or the criteria for a vendor to qualify. A conflict of interest may emerge where a committee member may also be considered as a candidate for critical vendor status. A committee member in this situation should abstain from voting on this request.

c. Bondholders and Unsecured Bank Debt

Bondholders and unsecured bank debt holders may oppose a critical vendor proposal, as the bonders and unsecured bank debt holders do not get such preferred treatment even though they would share pro rata any payments under a plan of reorganization. The bondholders are likely trapped creditors that will not provide the debtor any postpetition financing and thus not qualify as a critical vendor. Therefore, they complain that this class of creditor is unjustifiably preferred.

d. Asbestos and Mass Tort Claimants

Like the bondholder and unsecured bank debt holder, the asbestos and mass tort claimant may protest the preferred treatment of a critical vendor given that they may be treated as an unsecured creditor if their claim has been settled. Alternatively, the asbestos claimant may be grouped under a trust for payment and therefore see key vendors continuing to supply the debtor as central to maximizing the prospects for a debtor to exit Chapter 11.

e. Office of the United States Trustee

As an adjunct to the Justice Department, the Office of the United States Trustee is in a position to object to the critical vendor motion. The U.S. Trustee may oppose the critical vendor request if it is made in the opening days and creditors have not had an opportunity to respond.

5. Persuading the Bankruptcy Court

The bankruptcy court must approve a debtor's critical vendor motion. Even if no party objects to the motion, the court may deny the request. In light of Kmart, a debtor requesting approval of a critical vendor motion in the Seventh Circuit will include the elements considered by the Seventh Circuit (previously mentioned).

6. Postpetition Credit Sales: How Much Credit and Terminating the Credit Relationship

The Bankruptcy Code does not specify the amount of trade credit the vendor must provide to qualify as a critical vendor. However, debtors customarily condition critical vendor status on the vendor provid-

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ing comparable credit terms that the vendor provided within the year prior to the bankruptcy filing. Generally, the debtor forwards a letter agreement reciting the terms of the postpetition agreement.

Recent trade credit agreements approved by courts have required vendors to provide postpetition credit through confirmation of the Chapter 11 proceeding. If the vendor breaches the postpetition credit agreement, that may be cause for the vendor to disgorge the payment on account of the prepetition claim.

If the postpetition trade credit agreement does not contain a provision that allows for the vendor to terminate the trade relationship should the debtor fail according to the credit terms, the vendor should write in such a provision. Further, the vendor may want to include a provision that permits the vendor to terminate the trade relationship if the debtor falls below key ratios, even if the debtor has not defaulted on the postpetition credit agreement. This would allow the vendor to hold orders in the face of a debtor's deteriorating financial condition.

7. Waiving Alleged Preference Claims

A vendor that is deemed critical may find that it had already been paid on a portion of its prepetition claim during the preference period. *Even though the vendor may be deemed a critical vendor, that designation does not protect the critical vendor from a preference suit for payments received during the preference period.*

A vendor may consider insisting on a preference waiver as part of being appointed as a critical vendor. The court should approve the preference waiver.

8. Interplay of Reclamation

Article 2 of the Uniform Commercial Code, and the Bankruptcy Code, recognize that a vendor may be permitted to reclaim goods that were shipped within a specified time period of the bankruptcy filing. Most bankruptcy courts recognize that reclaiming creditors are entitled to administrative priority. Under the critical vendor doctrine, many debtors will pay vendors their prepetition claims that are not reclamation claims, which are entitled to administrative priority. The reclamation claims will be paid pursuant to a global reclamation order.

9. A Debtor's or Trustee's Right to Claw Back Critical Vendor Payments Upon Reversal or Conversion to Chapter 7

Kmart has raised the issue of whether a vendor that is selected as a critical vendor may later be sued to recapture the critical vendor payment in the event the critical vendor order be reversed, even if the vendor extended credit to the debtor as required under the critical vendor order. A vendor should consider including a provision in the critical vendor order that bars a claw back of the critical vendor payment should the order be reversed. The most effective way to gauge this risk is whether the critical vendor order was appealed. The general rule is that the critical vendor order must be appealed within 10 days of entry. Should a party fail to timely do so, the appeal is lost.

Does the critical vendor face risk that the critical vendor payment may be clawed back if the Chapter 11 be converted to Chapter 7 liquidation? If the critical vendor order provides that the vendor is free from such claims if the case converts from a Chapter 11 to a Chapter 7, that language should protect the vendor from any later claims asserted by a Chapter 7 trustee.

10. Failing to Qualify as a Critical Vendor; or, the Critical Vendor Program is Not Approved

a. Selling on Credit Postpetition

To encourage vendors to sell a debtor postpetition on credit, the Bankruptcy Code provides that should the debtor default on the credit sale, the vendor is entitled to an administrative claim for the unpaid balance. Unlike the critical vendor doctrine, a postpetition credit sale does not allow for payment on the vendor's prepetition claim.

b. The Catch Up Issue

If the vendor does not qualify as a critical vendor, the vendor may decide to find an alternative to have its prepetition claim paid. A vendor may not be paid on its prepetition claim post bankruptcy. However, a creditor may attempt to have the debtor pay down its prepetition debt by inflating its postpetition invoices. This "catch up" scheme may be illegal, and can result in disgorgement of the inflated invoices and, possibly, criminal action.

c. Junior Lien Sales

To those vendors who do not qualify as critical, a debtor may offer a junior lien on assets in exchange for their selling on credit. The purpose of the junior lien is to reduce the risk that if the debtor fails to pay for the credit sale, the vendor may have some assets to look to for payment. However, the junior lien sale does not pay a vendor's prepetition claim. Therefore, this alternative is more risky for the vendor.

d. Sale of Claim

A vendor that is not selected as critical may elect to sell its prepetition claim. Third parties, unrelated to the debtor, offer to purchase a trade creditor's prepetition claim, at a discount. Unlike the critical vendor doctrine, a vendor does not have a continuing obligation to sell the debtor on credit when it sells its claim to a third party. Also, unlike the traditional critical vendor doctrine, a vendor selling its claim does so usually at a steep discount.

F. Conclusion

The application of consistent and standardized rules governing the critical vendor doctrine nationally will likely take years. *Until the United States Supreme Court rules on this issue, or Congress intercedes, a debtor's ability to obtain authorization to make critical vendor payments may vary from court to court and district to district.* A debtor seeking this relief, and creditors working with debtors to seek this relief, should rely on more than mere equitable grounds as authority, and present more evidence that the critical vendor is truly indispensable to the debtor's continued business and reorganization.

Exhibit A (page 16):
Pre-bankruptcy Critical Vendor Agreement

Exhibit B (page 17):
Post-bankruptcy Critical Vendor Agreement

SUBCONTRACTORS AND MATERIALMEN: KNOW YOUR RIGHTS!

(*Continued from page 2*)

Illinois, Maryland, Michigan, New Jersey, New York, Oklahoma, Texas and Wisconsin). Generally, under a statutory trust, any money paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for the purposes of paying those subcontractors. Essentially, when a contractor or subcontractor receives payment for work on a construction project, those funds may be considered "trust funds" which are earmarked for payment of downstream subcontractors or materialmen.

If the trust funds are used for any other purpose, the contractor's or subcontractor's "managing agents" may become personally liable to any lower tiered subcontractors or materialmen who remain unpaid as a result. A "managing agent" is usually defined as any employee of a contractor or subcontractor who has direction over or control of money held in trust.

Contractual Trust

Contractual trusts are similar to statutory trusts in application, however, unlike a statutory trust which is created by the legislature, a contractual trust is created by agreement. Basically, the subcontractor or materialman can simply refuse to do business unless their contracts to perform include trust fund provisions. In the event that the owner or general contractor defaults on the debt, the trust provision will enable the subcontractor or materialman to preserve priority over the debtor's secured lenders. Practically speaking, subcontractors and materialmen will find general contractors and owners resisting this arrangement. The most common contractual trust for a subcontractor or materialman will involve three parties, the subcontractor/ materialman, the general contractor, and the owner.

The trust agreement will usually include language which states the contractor agrees that all funds received by the contractor to the extent those funds result from the labor or materials supplied by the subcontractor or materialman shall be held in trust for the benefit of the subcontractor or materialman. The trust agreement will also state that the contractor agrees it has no interest in the trust funds and to promptly account for and pay to the subcontractor or materialman all trust funds.

Trust fund laws or agreements are one way that a subcontractor or materialman can gain priority over a customer's bank that has a blanket security interest on receivables. The subcontractor or materialman is essentially saying that it will not provide the value of labor and materials if some other lender will have priority over the receivable that is generated by the labor and materials provided. The subcontractor or materialman can refuse to supply labor or materials unless it will have absolute first priority to the value provided. This absolute first priority is a trust fund agreement.

Joint Checks

Many construction contracts are written so that the owner will pay for labor and materials by way of joint checks. Typically, a contractor will submit a payment application itemizing work performed by various subcontractors during that month's payment cycle. The owner will then issue checks payable jointly to the general contractor and to the subcontractor whose work was listed on the application. This process can work to the subcontractor's advantage, because it prevents the general contractor from using payments earmarked for the subcontractor to satisfy other obligations.

However, the use of joint checks may present a number of complications. Some courts have held that a signature on a joint check constitutes payment even if the money was actually not received (i.e., the second party on the check kept all of the funds). The "joint check rule" states that when a supplier or subcontractor endorses a check payable jointly to him and the general contractor, he is presumed to have received all sums then owed to him, even though he actually may have received only part or none of the amounts owed to him. This rule presents a quandary for subcontractors and materialmen because they have to endorse the check if they want to be paid at all. However, their endorsement of the joint check creates a legal presumption that they have been paid the full amount of the check, even if the general contractor has withheld the funds or has otherwise reduced the payment.

The presumption that the subcontractor or materialman was paid everything owed up to the date the check was endorsed will be disregarded if an agreement exists between the subcontractor or materialman and the owner or general contractor as to allocation of the proceeds. As such, a subcontractor or materialman should obtain a written agreement from the owner and general contractor that his endorsement of the check is not an acknowledgement of payment of everything owed at the time of the endorsement, but is instead merely an acknowledgment of amounts actually paid. Failure to obtain such an agreement places the subcontractor or materialman at risk of never getting paid for the work not included in the joint check.

As a general rule of caution, if you intend to use any of the above mentioned remedies, you must comply precisely with the conditions for using them. Subcontractors and materialmen, protect your rights!

Guest Column

IN-HOUSE COUNSEL: A "GLASS CEILING" FOR CREDIT MANAGERS?

(*Continued from page 2*)

one stunning blow, the credit manager might be cut off from his/her network of creditors rights attorneys. That could be a big problem!

As an example, let's suppose that the creditor sells equipment to a contractor supplying a new industrial facility located in the State of California. If the contractor were to run into financial difficulty with the project, the creditor may need to find ways to protect itself.

In California, there is a requirement for a First Furnishing Notice if the creditor wishes to preserve any rights it may have under the state's mechanics lien statutes.

In the event that In-house counsel did not have experience with lien statutes, in-house counsel would presumably read the statute dutifully, and comply exactly with its requirements. However, a problem may arise in that in-house counsel might not take the time to find out how California courts have interpreted the mechanics lien statutes.

It turns out that California courts have been quite specific in what is required in order to comply with the First Furnishing Notice. Merely reading the statute, may send in-house counsel down the wrong course of action. Multiply this scenario by 49 other states, and the credit manager has a prescription for disaster! No one person can possibly know the requirements, court interpretations and quirks in all 50 states! Arguably what is needed, is an expert in each state.

Meanwhile, executive management is probably monitoring in-house counsel in order to see that the investment is worth it. In order to live up to these expectations, in-house counsel has every incentive to minimize the use of outside firms. Although this may at first sound very reasonable, a problem might arise if in-house counsel were to take on an assignment which should otherwise require a specialist; as in the above example.

In extreme cases, this "tension" in the working relationship between the credit manager and his/her in-house counsel might result in an apparent or actual conflict of interest. How might this conflict of interest arise?

In the event of a customer dispute, the credit manager may determine that he/she has good grounds to sue for $400,000 owing. In-house counsel for the creditor contacts the debtor's in-house counsel, and absent the legal discovery process, neither in-house counsel may really understand the true nature of the controversy. Together, they may decide that the best and most economical way to resolve the controversy is to try to reach a settlement.

The credit manager's in-house counsel may say to the credit manager something like, "will you settle for $200,000?" That "solution," minimizes or eliminates outside legal fees, although greatly increasing the credit manger's losses. Thus, "competing agendas" may exist on the part of the credit manager and its counsel. From the credit manager's perspective, the proposed solution if accepted would be quite a customer discount and perhaps a "penny wise and pound foolish" business plan. But who is to say which is the proper course of action given the uncertainty of litigation!

Added to this uncertainty, is executive management's perception and evaluation of both the credit manager and in-house counsel; perhaps in a total vacuum of the issues at hand.

Bankruptcy is also a specialized area of the law that may be beyond the comfort level of some in-house counsel. Consequently, it is incumbent upon bankruptcy practitioners to understand the strengths and weaknesses of their client's personnel -- which suggests that value-added marketing opportunities may exist.

Mr. Fox is not an attorney, and thus the foregoing is not intended to be, nor should it be construed as legal advice. Mr. Fox's opinions are his alone, and not necessarily those of his employer, its affiliates, nor any other party. Mr. Fox's background is more than 20 years business credit management experience, and he presently serves as Co-Chair of the UTC.

CHARTING THE CHANGES ON THE BANKRUPTCY PREFERENCE HORIZON

(*Continued from page 1*)

Protection Act of 2005 (BAPCPA), which is on its way to becoming law. The BAPCPA modifies the ordinary course of business defense using a disjunctive term between the second and third elements, therefore requiring the creditor to prove either the subjective prong or objective prong, but not both.

In U.S. Interactive, the Delaware bankruptcy court focused exclusively on the objective standard between the parties. The court stated that where there are a limited number of transactions between the parties (the particular aspect of the parties' relationship only began six months before the bankruptcy filing), the objective standard plays a more prominent role in the analysis than the subjective standard. The court went on to find that a definitive standard was required under the circumstances, and that the creditor's evidence failed to establish a definitive industry standard.

Under the BAPCPA, the proposed preference provision seeks to have the court look to the pre-petition history between the debtor and creditor as a definition of ordinary course of business. This would allow the creditor to avoid the expense of employing an expert as some courts require to prove up the industry standard – a clear advantage over the current law. On the other hand, should there be an insufficient history between the debtor and creditor, then the courts can look to industry norms to determine ordinary course of business. This would require the creditor to prove a definitive industry standard as outlined in U.S Interactive – a high standard that may be difficult to overcome.

JUST THE FACTS ABOUT THE FACT ACT: WHAT DOES IT MEAN TO THE CREDIT PROFESSIONAL ?

(*Continued from page 3*)

formation may have been obtained improperly. Wells Fargo Bank has had to make three separate disclosures to thousands of their customers stating private financial information stored by Wells Fargo may have been obtained by fraudsters.

The recent breaches of security at CheckPointe, Inc., and LexisNexis, highlight the need for more security procedures and legislation to ensure private financial records cannot be accessed by fraudsters. While the Fact Act allows states to legislate additional requirements and remedies to help thwart those seeking to steal identities, legislating tough federal standards may be the only way to consistently provide consumers with protection, and give businesses notice of the requirements they must meet when using and storing private financial information.

Attempts to Stop the Epidemic of Identity Theft

1. Securing Credit Card Information

One of the main goals of the Fact Act is to help consumers monitor their credit more effectively. The Fact Act helps to close the door on would be thieves of credit information by mandating that receipts for credit and debit card transactions may not include more than the last five digits of the card number or expiration date. The effective date of this provision is a long way off for some vendors and there are also some loopholes. The mandate does not apply to receipts that are by handwriting or by an imprint or copy of the card. If the credit processing machine was in use before July 1, 2005, the vendor has three years to comply. Also for machines in use after January 1, 2005, the vendor has one year to comply.

2. Obtaining Documents Used to Steal an Identity

The first step for an identity theft victim to regain financial health is gaining copies of the fraudulent documents the thief used to steal their identity. As of June 1, 2004, a vendor that provides credit or products and services to an imposter using another's identity must give the victim copies of the documents used, such as applications for credit or transaction records. The vendor must also provide copies of the fraudulent documents to any Federal, state or local law enforcement agency the victim specifies.

There are exceptions though. A vendor is not required to turn over the fraudulent documents if they do not have a high degree of confidence that the consumer requesting the fraudulent documents actually owns the true identity. A vendor does not have to turn over the fraudulent documents if the request contains a misrepresentation of fact, or the information is internet navigational data.

A vendor can be sued for not turning over the requested fraudulent documents, but only from a government agency and if the vendor does not make a good faith effort to comply.

3. Collection Agencies and the Fact Act

Usually the first notice a consumer receives that their identity has been stolen is when a collection agency calls them to collect a debt. If a vendor sends a debt to be collected by a collection agency, and the victim notifies the collection agency that the debt resulted from the theft of their identity, the collection agency under the Fact Act is required to give notice to the vendor. A vendor, once notified of the identity theft and the creation of a fraudulent account, cannot sell the debt or place it for collection. This provision took effect December 1, 2004.

4. Red Flag Procedures

The Fact Act will eventually require certain entities to institute procedures designed to catch identity theft before it takes place. There are certain events that are red flags to identity theft such as a change of address, a request for a replacement credit card, or efforts to reactivate a dormant credit account with a vendor. A consumer's ability to protect themselves from identity theft is limited. Much of the problem is a result of inadequate procedures on the part of businesses. The Fact Act instructs the Federal Trade Commission to adopt regulations that establish guidelines for red flag behavior and the proper response. These guidelines have yet to be published for public comment.

5. Proper Disposal of Credit Information

Irresponsible credit information disposal has led to many cases of identity theft. Under the Fact Act, if a vendor uses a consumer credit report for the extension of credit, the vendor must adopt procedures for the disposal of the reports. This provision is attempting to eliminate the wealth of information gained from fraudsters dumpster diving.

Conclusion

The Fact Act provides valuable new legislation which allows consumers to monitor and protect their credit more effectively. In the future, credit professionals should expect more federal legislation governing the storage, use, and protection of all forms credit information.

SCRUTINIZE YOUR PREFERENCE SETTLEMENT: ARE YOU GIVING UP YOUR REPLACEMENT CLAIM?

(*Continued from page 3*)

ment that any vendor that receives a greater payment disgorge the payment so that like vendors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period may be recaptured. The three most commonly used defenses by vendors are the contemporaneous exchange, new value and ordinary course of business defense.

B. Replacement Claim Under the Bankruptcy Code

Bankruptcy Code section 502(h) recognizes that a creditor is entitled to an unsecured, prepetition claim for every preference dollar repaid. Thus, the Replacement Claim shares equally with the general unsecured creditors. Given the Bankruptcy Code's recognition that the vendor is entitled to the Replacement Claim, the vendor must consider the following statement from a debtor in pursuing a preference claim:

> "Please note that, upon making this preference repayment, however, your company will not be granted a claim in the Debtor's bankruptcy case for this amount paid, nor will this resolution effect any other claims between the debtor and your company."

As the Bankruptcy Code recognizes a vendor's right to a Replacement Claim, the vendor should agree to waive this claim only upon receiving comparable value for the Replacement Claim. But what is the value of the Replacement Claim? The debtor's disclosure statement will set forth the range of estimated payment to unsecured creditors. Does the disclosure statement control the range of value for the Replacement Claim? Does the disclosure statement's range of estimated payout control a distribution on a Replacement Claim, especially if the proposed payment on the Replacement Claim is well after confirmation of the plan?

C. Valuing Your Replacement Claim

Key in determining whether to waive your Replacement Claim in settling the preference suit is the value of the Replacement Claim. The party pursuing the preference action will usually assign a range as to the expected distribution on the Replacement Claim. However, there is no guarantee that is indeed what will be distributed on the Replacement Claim. You may again consider the disclosure statement to determine the range of distribution. However, that range may increase or decrease based on such factors as recoveries on preference claims and other litigation, as well as administrative costs from attorneys and others. Further, the distribution range does not take into account the time value of money. There may be sizeable delays with a distribution to creditors.

D. Waiving Your Prepetition Claim

Separate from the Replacement Claim, to avoid paying fresh money to settle the preference claim, consider waiving your prepetition claim. The prepetition claim will have a bankruptcy dollar assigned to the claim. Offsetting the prepetition claim with your preference claim allows you to reduce or eliminate any money you must repay where you have preference exposure. Waiving your prepetition claim must be by agreement with the trustee, and may be subject to bankruptcy court approval.

E. Where Do Preference Recoveries Go?

Too often credit professionals that are forced to repay preference payments, and are attempting to determine when payment will be forthcoming are met with resistance by the parties pursuing the preference recoveries. After a plan has been confirmed, the vendor may be forced to request the bankruptcy court to order the preference plaintiff to disclose the amount of money they have recovered and the amounts they will be distributing to vendors holding Replacement Claims.

F. Scrutinize Your Preference Settlement Agreement

Preference actions may require you to return some payments. In that event, you are entitled to a Replacement Claim. Given this, you need to review your settlement agreement to ensure that you are not inadvertently waiving this claim. If you elect to waive the Replacement Claim, analyze the range of value to make sure that you are getting top dollar for the Replacement Claim.

STOPPING GOODS IN TRANSIT AND RECLAMATION DEMANDS UNDER CHECK 21: DOES THE VENDOR NOW HAVE GREATER PROTECTION WHEN ACCEPTING PAYMENT BY CHECK?

(*Continued from page 4*)

late with the debtor for the immediate return of the goods or for the debtor to sell the goods, provided the vendor is granted an administrative claim or a lien under the Bankruptcy Code.

If there are no bankruptcy proceedings, the vendor must initiate legal action in state court pursuant to the UCC. The vendor should bring a complaint for replevin and a writ of attachment against the proceeds of any sale of goods protected by the reclamation demand.

A vendor has the burden to establish that the debtor was insolvent at the time the debtor received the goods. Courts strictly enforce the requirement that the goods be in the possession of the debtor when reclamation is demanded. If the debtor has transferred the goods to a good faith purchaser before the reclamation demand is made, the reclaiming vendor loses all reclamation rights to the goods. As a result of Check 21, the vendor may more easily establish this element as the vendor may be able to make a more timely reclamation demand, given the prompt notice under chapter 21 of the NSF check.

Some courts have determined that a secured creditors right will extinguish all of the reclaiming vendor's rights. Therefore, only those goods that were sold to the debtor prior to the filing were subject to any security interest.

Although difficult to get, the vendor should insist upon a lien on the assets of the bankruptcy estate, rather than an administrative claim. An administrative claim will not get satisfied if the bankruptcy case is administratively insolvent. A vendor's lien under the Bankruptcy Code is measured by the price realized by the debtor for the goods sold. As such, an agreement as to the amount of the lien or claim is advisable, so as to avoid recovering less than the resale price of the goods.

(*Continued on page 15*)

STOPPING GOODS IN TRANSIT AND RECLAMATION DEMANDS UNDER CHECK 21: DOES THE VENDOR NOW HAVE GREATER PROTECTION WHEN ACCEPTING PAYMENT BY CHECK?

(*Continued from page 14*)

Like a vendor's stoppage rights, Check 21 should aid the vendor making a reclamation demand as the vendor should learn earlier of the NSF and, therefore, make a more prompt reclamation demand.

C. Overview Of Check 21

Approximately 75 percent of trade credit transactions are conducted by check. Check 21 focuses on the delay caused by a paper check being transported through the banking system.

Check 21 permits the depository bank, if it so chooses, to "truncate" the original check. Truncating a check means to take the check out of physical circulation by transforming it using a computer scanner into a digital image, also known as a substitute check. This digital image becomes the legal equivalent of the original check, provided it meets the criteria set out in the legislation. Truncating the check permits banks to process the digital image for payment in hours rather than days. As a result of image technology, check delays attributable to weather or air travel are gone.

D. Check 21 Makes the Remedies of Stopping Goods in Transit and Reclamation More Valuable

Check 21 better protects vendors from the risks of an NSF check, especially the typically lengthy time it takes to learn that the check does not clear, especially an out-of-state check has not cleared. As a result of image technology, vendors will receive notice of the NSF check and can take steps to protect the sale, including a more timely demand to stop goods in transit or reclamation demand.

EXHIBIT A

BY FAX, FEDERAL EXPRESS, AND CERTIFIED MAIL

Re: Reclamation Demand by (Vendor)

Dear Sir/Madam:

Demand is hereby made upon you pursuant to Sections 2-507, 2-511 of the Uniform Commercial Code, and Section 546(c) of the United States Bankruptcy Code, for the return of goods that the undersigned had sold to you on cash terms and for which the check(s) tendered in payment for the goods were dishonored, which goods were received during the applicable reclamation periods. This demand specifically includes, but is not limited to all goods described in the Schedule annexed hereto.

Please contact the undersigned for instructions for return of the goods. You are further notified that all goods subject to our right of reclamation should be protected and segregated by you and are not to be used for any purpose except those authorized following notice and a hearing by the Bankruptcy Code.

Very truly yours,

SCHEDULE TO RECLAMATION DEMAND

Invoice No.	Invoice Date	Invoice Amount

THE CRITICAL VENDOR DOCTRINE AFTER KMART:
CAN YOU STILL GET PAID NOW, IN FULL, ON YOUR BANKRUPTCY CUSTOMER'S ACCOUNT?
(*Continued from page 10*)

Exhibit A: Pre-bankruptcy Critical Vendor Agreement

CRITICAL SUPPLIER AGREEMENT

THIS AGREEMENT between [vendor] ("[vendor]") and [customer], a _____________ corporation ("[customer]") takes effect on __________ __, 200_.

Background:

[vendor] is a supplier of one or more necessary and critical products or services that [customer] uses in connection with its operations. Without this product or service, [customer] would face a possibly irreparable impact on its ability to continue operations and retain customers. [customer] 's recent purchases of this product or service from [vendor] on open account has averaged approximately $________ on a monthly basis. [customer] has asked [vendor] to continue to extend credit to [customer] to permit [customer] to continue to purchase this product or service on open account and, in addition, to extend ___ day payment terms to _______________.

Subject to the terms and conditions of this agreement, [vendor] is willing to extend this additional credit to [customer] for an agreed time period in consideration of entering into and performing this agreement.

The Agreement:

In consideration of the covenants and agreements herein contained, the parties agree:

1. The recitals above are made a part of this agreement.
2. [customer] agrees that if a bankruptcy proceeding is instituted or a finding that [customer] is adjudicated a debtor as a result of an involuntary petition filing, then [customer] will use its best efforts to seek full relief for [vendor] as a "critical supplier" or "critical vendor" of [customer].
3. [vendor] agrees to extend __-day payment terms to _______________ through ____________, 200_. [customer] agrees that its strict compliance with such payment terms constitutes a fundamental term of this agreement and that its failure to so comply constitutes a material breach of this agreement. Notwithstanding anything to the contrary contained herein, [customer] agrees that if a Proceeding occurs and the appropriate court does not designate [vendor] as a "critical supplier" or "critical vendor" and order payment of [vendor]'s pre-Proceeding debt, [vendor]'s obligation to extend credit and such payment terms in connection with post-Proceeding sales to [customer] is null and void without prior notice. [Customer] further agrees that these provisions and any deemed termination or modification thereof are not conditioned on any of the events or conditions referred to in section 365(e) of the U.S. Bankruptcy Code or any similar law.
4. [Vendor] agrees to waive its rights under section 365(c)(2) of the U.S. Bankruptcy Code provided [vendor] is named a critical vendor and paid as to its prepetition claim within 30 days of the Chapter 11 filing.
5. [Vendor] can in its sole discretion terminate its postpetition credit line if it becomes financially insecure with [customer] ability to honor the terms of the postpetition credit sales.
6. No waiver by [vendor] of any default shall be effective unless in writing nor shall it operate as a waiver of any other default or of a similar default on a subsequent occasion. [vendor] has the right at all times to enforce the provisions of this agreement in strict accordance with the terms hereof, notwithstanding any conduct or custom on the part of [vendor] in refraining from so doing at any time or times. The failure of [vendor] at any time or times to enforce its rights under said provisions strictly in accordance with the same shall not be construed as having created a custom in any way or manner contrary to the specific provisions of this agreement or as having in any way or manner modified the same.
7. This agreement is governed by, and shall be construed in accordance with, the law of [vendor's location], without reference to conflicts of law principles.
8. This agreement may be executed in any number of counterparts each of which when executed and delivered will be an original, but all the counterparts together will constitute one and the same instrument.

Dated: _______________________

ATTEST	[vendor] COMPANY
______________________________	_________________________________
ATTEST	[customer]
______________________________	_________________________________

(*Exhibit B on page 17*)

THE CRITICAL VENDOR DOCTRINE AFTER KMART:
CAN YOU STILL GET PAID NOW, IN FULL, ON YOUR BANKRUPTCY CUSTOMER'S ACCOUNT?

(*Continued from page 16*)

Exhibit B: Post-bankruptcy Critical Vendor Agreement

[DEBTOR]

_____________, 200_

TO: [Critical Trade Vendor]
[Name]
[Address]

Dear Vendor:

As you are no doubt aware, [DEBTOR NAME] and certain of its affiliates ("Debtors"), filed a voluntary petition under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy court for the District of _______________ on _________________ (the "Petition Date"). On the Petition Date, we requested the Bankruptcy court's authority to pay certain suppliers. On _________200_, the Bankruptcy Court authorized us to pay prepetition claims of certain trade creditors that agree to the terms set forth and to be bound by the terms of the Order.

In order to receive payment on prepetition claims, each selected trade creditor must agree to continue to supply goods to the Debtors based on "Customary Trade Term." Customary Trade Terms are defined as the normal and customary trade terms, practices and programs (including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowances, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs) in effect between such trade creditor and the Debtor for the period prior to the Petition Date or such other trade terms that are at least as favorable as those that were in effect during such time.

For purposes of administration of this trade program as authorized by the Bankruptcy court, the Debtors and you agree as follows:

1. The balance of the prepetition trade claim (net of any setoffs, credits or discounts) (the "Trade Claim") that the Debtor will pay you is $__________________.

2. You will provide open credit terms as follows: ____

3. The open trade balance or credit line that you will extend to the Debtor for shipment of postpetition goods is $_________ : ((a) on __________200___, or; (b) on normal and customary terms on a historical basis for the period immediately before the Petition Date).

4. Payment of your claim may only occur upon execution of this letter by a duly authorized representative of your company and the return of this letter to the Debtor.

Sincerely,
[Applicable Debtor]

By: ____________________________

Its:_________________________-

Agreed and Accepted by:
[Name of Trade Vendor]

By: __________________________

Its:________________________ Dated: ________________________

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Spring 2005

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

◊ Scott was quoted in the New York Times concerning the bankruptcy amendments and offshore and domestic trusts.

◊ Scott spoke to the **NACM/North Central** in Las Vegas regarding **Escheatment.**

◊ Scott spoke at a teleconference for **What's Working in Credit** concerning **Bankruptcy Preferences**.

◊ Scott spoke to **NACM/Chicago-Midwest's** industry group in Las Vegas regarding **Sarbanes Oxley**.

◊ Scott spoke to **NACM/Chicago-Midwest's National Metal Manufacturer's credit group** in San Diego regarding **Sarbanes Oxley.**

◊ Scott spoke at a teleconference for **What's Working in Credit** concerning **Check 21**.

◊ Scott spoke at a teleconference for **IOMA** regarding **Check 21**.

◊ Scott spoke to **NACM Kansas City's Golf Manufacturer's Credit Group** in Orlando regarding **Sarbanes Oxley** and **Escheatment.**

◊ Scott spoke at a teleconference for **IOMA** regarding the **Critical Vendor Doctrine.**

◊ Scott spoke to **NACM/Chicago-Midwest's Home Centers Industry Group** in San Diego regarding **What's Hot with Payment by Checks.**

◊ Scott spoke to **Reimer Reporting's National Bicycle Manufacturer's Industry Group** in Phoenix regarding **Check 21.**

◊ Scott spoke to **NACM/Chicago-Midwest** in San Francisco regarding **Check 21.**

◊ Scott spoke to the **Orange County Credit Professionals** regarding the **Critical Vendor Doctrine**.

◊ Scott spoke to **NACM/Oregon's National Apparel and Footwear Credit Association** in San Diego regarding **Sarbanes Oxley**.

◊ Scott spoke to the **Summit Financial Group's National Electrical Distributors Credit Association** regarding **Check 21**.

◊ Scott spoke to **NACM/Chicago-Midwest's Paper and Packaging Group** in San Diego regarding **Sarbanes Oxley**.

◊ Scott spoke to the **L.A./Valley Credit Professionals Group** regarding **Into 2005: Hot Credit Topics**.

◊ Scott spoke at the **Credit Research Foundation Conference** in Rancho Mirage regarding **Check 21**.

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