Blakeley & Blakeley LLP

Spring 2007
www.bandblaw.com

THE TRADE VENDOR QUARTERLY

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

EMAIL, DISPUTED ACCOUNTS AND THE COURTS

Scott Blakeley
seb@bandblaw.com

Email is revolutionizing how credit professionals do their work. Whether using email to automatically invoice customers through their Web site, to automatically posting payments, to gathering credit information, including credit reports, credit professionals are now handling virtually all of their responsibilities electronically. Email is also being used to alert credit association members of problem accounts, communicate with credit peers, communicate with customers, including sending invoices and order acknowledgments across computer networks, and using email to collect delinquent accounts. Likewise, customers can provide credit professionals via email confidential financial information to assist with the credit analysis, as well as negotiating credit terms via email. Underscoring the explosion of email use, businesses around the world are estimated to send over a trillion email this year.

Consider the following common situation when using email to communicate with a customer: you sell specially manufactured goods. The customer disputes the invoice complaining that the shipment contained defective product and refuses to pay. Your salesperson visits the customer and inspects the shipment. He emails you on his PDA that he believes that shipment was in fact defective. If you are forced to sue to collect on the delinquent account, may the customer obtain a court order directing you to turnover a copy of the salesperson's email through electronic discovery? Must you turn over the email if the customer subpoena's all email? Recent court developments highlight how the company must deal with this topic and the importance of that the credit department must put on managing emails and the responsibility to preserve email if litigation is commenced.

Email A Hot Topic With The Courts And Congress

While email is now the favored way for the credit professional to communicate with customers, credit colleagues and employees, email can also be a rich source of information for customers where litigation or arbitration is required to collect on a delinquent account. Not only has the credit professional's use of email expanded in recent years, but retaining those emails has become complicated as the emails may be scattered over servers, laptops, PDA's and home computers. Likewise, the emails containing discussions with the customer may be contained over a number of emails and from others in the credit department and sales force. And it is not just the use of email that has exploded, but the forms of e-information, from instant messaging, PDA's, web-based emails and voice mails. This form of einformation may also be subpoenaed by a customer in the event of litigation in the form of e-discovery.

(*Continued on page 5*)

RESURRECTING A GUARANTOR'S LIABILITY FOR PAYMENTS AVOIDED AND RECOVERED AS PREFERENTIAL TRANSFERS

Bradley Blakeley
bblakeley@bandblaw.com

Vendors forced to return a portion or all of transfers by their bankrupt customer may not be without recourse. In a case where the creditor has obtained a guaranty of the customers debt, that creditor may seek to resurrect that guarantor's liability for the transfers returned in a preference action related to their customer's bankruptcy. This was the outcome in the bankruptcy case of *In re Quality Takes Time, Inc.* from the Middle District of Tennessee.

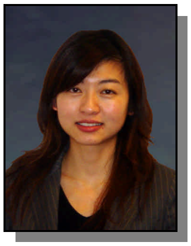
In *Quality*, the guarantor was the president and sole shareholder of the debtor prior to it being placed into involuntary bankruptcy. The guarantor had given the creditor an unconditional continuing guaranty for the debts of the debtor, and the debtor paid the creditor a payment during the preference period. The bankruptcy trustee filed an action seeking to avoid and recover the payment and the creditor filed a third-party complaint against the guarantor. The creditor asserted that if the payment was determined to be a preference that may be avoided by the trustee, then the guarantor should still be liable on the guaranty. On cross-motions for summary judgment, the court found that the guarantor could be held liable on the guaranty if debtor's bankruptcy estate was successful in recovering payment on debt as preference.

(*Continued on page 6*)

CONTENTS

COURT FINDS DEBTOR GUILTY OF BEING OVERLY OPTIMISTIC BUT NOT FRAUDULENT IN ITS PAYMENT PROMISES

Shirley Chen
schen@bandblaw.com



A recent bankruptcy court decision discussed the dischargeability of a debt when the creditor's friendship with the debtor skewed the judgment of the creditor in renewing the business relationship despite the debtor's poor payment history.

In *In re Shadinger*, 2006 WL 3591254 (Bkrtcy, N.D. Ala.), Darrell Shadinger ("Debtor") and his wife filed a chapter 7 bankruptcy petition. A supplier commenced an adversary proceeding against the Debtor. The supplier claimed the Debtor is personally liable for an unpaid open account incurred through a series of credit sales by the supplier to the Debtor's company. The supplier asserted the debt was incurred as a consequence of the Debtor's false representations. The supplier claimed that the Debtor should not be discharged from his liability for this particular debt under sections 523(a)(2)(A) of the Bankruptcy Code.

The supplier manufactured and supplied unfinished textiles, including cotton athletic socks. The Debtor was a textile finisher where the company would finished cotton socks purchased from a supplier of unfinished textiles. The textile finisher would take the unfinished socks and bleach, border, pair, bag and band them into a finished product ready for retail sale.

The Debtor and the supplier were friends, and they socialized and ate together from time to time. From 1998 to 2000, the Debtor purchased unfinished textiles from the supplier. The supplier would fill purchase orders, and payment would be made on a revolving open account basis. Because of the textile finisher's consistently poor payment habits, the supplier stopped filling the purchase orders in November 2000.

In early 2002, a representative of Ellis Hosiery ("Ellis") contacted the Debtor. Ellis Hosiery held the exclusive right to use the Reebok logo on athletic socks and asked if the textile finisher would have an interest in supplying finished Reebok socks. The Debtor asked the supplier if it would be willing to supply the unfinished socks.

In light of the textile finisher's poor payment history, the principals of the supplier were concerning about renewing the business. However, because of the friendship between the owner of the supplier and the Debtor, and because it appeared the Ellis-Reebok orders could be substantial and profitable for both the supplier and the textile finisher, the supplier agreed to supply the unfinished socks.

Although substantial and frequent payments were made on the account, after the first few months the textile finisher was again delinquent on its payments to the supplier. According to the supplier, the Debtor gave repeated assurance that the textile finisher would eventually pay its account balance and it has sufficient inventory and future business to produce enough revenue to pay the textile finisher.

The supplier asserted that the debt was nondischargeable under section 523(a)(2)(A). The supplier claimed that the Debtor must have known at the time he was giving assurances of payment that his statements were false because he was fully aware of

(Continued on page 6)

FROM THE PUBLISHER:

***The Trade Vendor Quarterly** is published by the law firm of Blakeley & Blakeley LLP and is distributed as a service to clients and other parties interested in creditor issues. This information is not intended to constitute legal advice, nor a substitute for legal advice.*

Blakeley & Blakeley LLP cannot be held responsible for the accuracy of information contained in articles written by guest contributors. Readers' comments and questions are welcome and should be addressed to:

Scott Blakeley
Blakeley & Blakeley LLP,
1000 Quail Street, Suite 200
Newport Beach, California 92660
Telephone: 949-260-0611
Facsimile: 949-260-0613

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

Guest Column

THE CRISIS MANAGER—THE EXPERT IS THE ALLY IN CHAPTER 11 REORGANIZATION

Al Chavez
achavez@phoenixadvisoryllc.com

Crisis managers hired to assist in a Chapter 11 are frequently viewed with suspicion, and their role in the process is often deemed unnecessary, if not purely detrimental to the outcome of the process. This is a mistaken perception held by many. A crisis manager can be the neutral party who possesses the experience and expertise to ensure that transactions provide the most benefit to all interested parties, and that they occur legally and according to required procedures.

A few years ago, I was retained as the interim Turnaround CFO in a manufacturing company that was in Chapter 11. One of the first motions we prepared was a cash collateral motion. A cash collateral motion, if granted, enables the Debtor to use cash or cash equivalents for pre-defined ordinary course activities, subject to timing and securitization issues. The motion was approved by the Court despite being objected to by the secured lenders. Having a Cash Collateral agreement is a very good thing for the Unsecured Creditor group as long as the terms are reasonable.

Contemporaneous with reporting, financing and operational issues inherent with Chapter 11 filings, we began the process of finding an initial buyer or "stalking horse" to start the 363 process. A Section 363 sale in bankruptcy is a restructuring tool that enables the smooth transfer of assets free and clear of encumbrances and interests. The Debtor went into the filing without DIP (debtor-in-possession) financing and like similarly situated companies, was in a liquidity crisis. The 363 process took longer than anticipated and it became evident that we would have to go back to Court for an extension of the use of cash.

Prior to my involvement as Turnaround CFO, the Debtor had been in negotiations with a significant customer for a major contract. Without this contract, it would have been impossible to obtain Court approval for the continued use of cash. The Debtor's

(Continued on page 8)

SHOPPING FOR A BANKRUPTCY COURT: WHAT IT MEANS TO THE CREDIT PROFESSIONAL

Ryan Wood
rwood@bandblaw.com

A multi-billion dollar corporation is going to file bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. The insolvent corporation's headquarters and thousand of employees are located at 18400 Von Karman Ave, Irvine, California. The insolvent corporation is located in the district of the United States Bankruptcy Court for the District of Central of California. The Central District is more than capable of administering the estate of the insolvent corporation and approving a plan of reorganization that provides for a realistic chance of repayment of creditors, or a fair distribution of what assets are available to unsecured creditors. Nevertheless, the insolvent corporation files for bankruptcy protection under Chapter 11 in Delaware.

You may have read about the recent bankruptcy filing of New Century Financial Corporation. So why would New Century file for bankruptcy protection in Delaware, and how is this allowed under the Bankruptcy Code? We shall scrutinize why large corporations forum shop when filing bankruptcy and what it means to the credit professional.

Venue

The choice of venue is probably the most important pre-bankruptcy decision a debtor can make given the current state of forum shopping. Venue is governed by Bankruptcy Code provisions 28 U.S.C. §1408 and §1409, which allow a corporation to file bankruptcy in their state of incorporation. While New Century Financial Corporation is a Maryland corporation, its subsidiary and holding company, New Century TRS Holdings, Inc., is a Delaware corporation. Therefore, New Century Financial Corporation and its subsidiaries were allowed to file bankruptcy in the United States Bankruptcy Court for the District of Delaware.

Bankruptcy Reform Act of 2005

The Bankruptcy Reform Act of 2005 originally contained provisions that would have limited the ability of corporations to choose the forum in which they are allowed to file bankruptcy. The reforms would have eliminated the state of incorporation as a separate basis for venue. The provisions would have prevented corporations like New Century Financial Corporation to use a subsidiary like New Century TRS Holding, Inc. to allow for venue in Delaware. These provisions were in the original reforms, but powerful lobbying by Delaware and New York congressman prevented the reforms from every becoming law.

What Forum Shopping Means to the Credit Professional

The result of forum shopping means the credit professional will unfortunately receive less on their claim. The first problem is being forced to seek payment in a distant and inconvenient venue. The increased costs range from increased travel expenses, to being forced to hire local counsel, as well as hire Delaware counsel, to assist with filings and other procedural matters when the venue is in another state such as Delaware. Another issue facing the credit professions is the development of statistics showing that creditors obtain a lower return in states such as Delaware and New York. Part of the problem is the loss of control of professional fees. Another problem is the growing trend to allow payment to a few critical vendors when a portion of these payments would go to unsecured creditors. The fact that Delaware and New York have both become debtor friendly jurisdictions is no secret. Until Congress revisits bankruptcy reform again, which will probably be a substantial amount of time, forum shopping will be part of the decision making process of debtors to the detriment of creditors.

MISSPELLING DEBTOR'S NAME RESULTS IN CREDITOR'S LOSS

Scott Blakeley
seb@bandblaw.com

In dealing with a new customer with a poor credit history, or an existing customer that is now in financial difficulty, the credit professional must find the balance for reducing credit risk, yet working with the salesforce to make the credit sale. A credit enhancement, whether, for example, in the form of a letter of credit, guarantee, deposit account or security interest, can reduce or eliminate the credit risk, yet still make the sale. However, selecting the credit enhancement and convincing the debtor (and possibly the secured creditor) is only part of the hurdle. If the credit enhancement agreed to is a security interest in your goods (PMSI) or a comprehensive security interest in all of the debtor's assets (blanket lien), then you must strictly comply with Article 9 of the Uniform Commercial Code, and failing to do so may result in the loss of your security interest and possibly no payment.

The recent decision of *Pankratz Implement Co. v. Citizens Nat. Bank*[0] reminds vendors that they must strictly comply with Article 9, including filing a UCC-1 financing statement that accurately spells the debtor's name or risk that a misspelled name may result in the vendor's financing statement being "seriously misleading" -- and risk a bankruptcy trustee or creditor unseating the lien.

Security Interest in Debtor's Assets?

In *Pankratz*, the vendor filed a financing statement claiming to take a security interest in the debtor's assets. The debtor's name was "Rodger House;" however, the vendor filed a financing statement spelling the debtor's name as "Roger House". A third party creditor filed a lawsuit to unseat the lien of the vendor, contending that the financing statement was seriously misleading and therefore the security interest was not properly perfected. The vendor contended that the misspelled error was a minor error that should not result in the loss of the security interest. The trial court found that although the debtor's name was misspelled, it was not seriously misleading to a party conducting a lien search. The creditor ap-

(*Continued on page 7*)

CHECK 21 AND NEW TECHNOLOGY AIDS THE CREDIT DEPARTMENT

Scott Blakeley
seb@bandblaw.com

Check 21 (The Check Clearing for the 21st Century) is improving way credit professionals handle customer payments. Yet even with the ever-increasing use of electronic forms of payment by customers, from ACH to electronic bill presentment to wire transfers and credit cards, payment by check is still the most common method for customers to pay. The arrival of new technology applying certain provisions of Check 21 to the credit department makes accepting payment by check much easier. For example, if the vendor does not use a lock box to collect customer checks, but instead the checks are mailed to the vendor's credit department, the credit professional may now use software to create electronic images of the check. These developments are discussed below. Check 21 went effective in October, 2004.

A. Background

The Federal Reserve Board, along with the banking industry, promoted check truncation and electronic check presentment to reduce the considerable time the original check takes to be transported through the banking system, which would speed-up the check clearing process.

B. Key Concepts Of Check 21

Check 21 is comprehensive legislation regulating the check collection process, but it does not require banks to truncate or convert checks into an electronic image. Check 21 does require banks to accept the truncated checks as the legal equivalent of the original. Check 21 encourages banks to voluntarily agree to convert checks into electronic versions for collection and clearing process.

1. Truncation

Check 21 permits the depository bank or vendor to truncate the original check. Truncating a check means to take the check out of physical circulation by using a computer scanner to convert the paper check into an electronic image. This electronic 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 it for payment much faster than if the check were paper. As a result of image technology, delays in processing paper checks attributable to weather or air travel are gone.

2. Substitute Checks

Check 21 authorizes the creation of a new payment instrument, the substitute check which is key to the legislation. The substitute check is a printout or image of the truncated check that is the legal equivalent of the original check when it meets certain requirements. The substitute check must contain images of the front and back of the check, conform to industry standards including MICR and physical characteristics of a check, accurately represent all information on the original check, bear a legend, include the endorsement and be suitable for automated processing in the same manner as the original check.

A substitute check may be found in: periodic statements from a bank; when viewing check images while performing online banking; when a customer requests a copy of the paid check from the bank; or, as a deposited check that is returned unpaid.

Check 21 does not require that the original check be returned to the customer. Check 21 also does not impose any minimum time period to keep the original check.

Under Check 21, no party can insist on receiving the original or a copy of the original check. Rather, when the original check is requested, a substitute check may be issued. As Check 21 makes a substitute check the legal equivalent of the original check, other laws regulating checks, such as the Uniform Commercial Code, apply to substitute checks to the extent consistent with Check 21.

3. Substitute Check Warranties

When a paper check is truncated and a substitute check is provided, the party truncating the check makes warranties to the accuracy and legal standing of the substituted check.

The significance of a breach of a Check 21 warranty is that this may lead to a recovery for damages. Damages under Check 21 are limited to the amount of the substitute check. When a party breaches a Check 21 warranty, the damaged party may also seek consequential damages and recovery for other losses related to the substitute check.

Check 21 provides that a party that transfers, presents, or returns a substitute check and receives consideration for the check warrants that the substitute check meets the requirements for legal equivalence. This warranty is made to the following entities: all other banks to whom the substitute check is transferred; the drawer; the payee; the depositor; and any other endorser.

C. New Technology, Check 21 and the Impact On The Credit Department

With the arrival of Check 21 and image software, the credit department need not make repeated trips to the bank. With the new remote deposit software that is available to the credit department, and complies with the provisions of Check 21, the credit professional can use a scanner that turns a customer's paper check into a screen image that is deposited over the internet.

The scanner may be connected to the company's accounting software, and can also print the date and time of deposit on the back of the check. However, certain checks are ineligible for conversion, such as: Business checks printed on 8 to 9 inch check stock, checks greater than $25,000, third party checks or sharedrafts, checks provided by credit card issuer, and cashier's checks

In addition to the convenience that Check 21 offers vendors in creating images of checks, another benefit is the end of the float on a customer's check, especially with out-of-state checks. A customer may count on a few days of check processing delays from the time they issue a check to give them time to collect funds to cover the check. Customers who attempt to gamble the float are likely to find themselves in an overdraft and facing bad check fees and payment demands from creditors. A check to a supplier can be scanned by the creditor's bank and sent electronically to the customer's bank for payment. Customers must have sufficient funds to cover payment when a check is issued.

EMAIL, DISPUTED ACCOUNTS AND THE COURTS

(Continued from page 1)

In this setting where a customers, including a bankruptcy trustee's preference claims, are looking to your emails to build their cases, the credit professional needs to be mindful that a poorly written email's meaning can be misconstrued. This requires that that the credit professional thoughtfully compose emails with an eye that they may ultimately end up in a court file, as email and e-information can be used to assist in testimony whereas a phone conversation is easily forgotten.

Thus, seemingly unimportant or poorly worded or thought out emails written by a credit professional or salesperson may be used to support a customer's claims that a debt is rightfully disputed. Given this, at first blush, the credit professional may be inclined to delete or purge emails that a customer subpoenas that may appear damaging to the collection effort, or weaken a preference defense in a preference suit. However, as discussed below, a deleted email trail can both weaken a vendor's defense and result in a court's finding of a presumption of guilt.

Popular press has highlighted the hazards of email, both retaining them and not doing so. For example, with Enron a stored email from in-house counsel raising concerns about accounting improprieties served as a roadmap for federal prosecutors. In another example, several Wall Street investment banks are facing multimillion dollar fines for not keeping emails. These recent headlines highlight the significance of email and raise the question of the credit professional's email retention program. Recent court decisions involving email sanctions include:

In *Zumbulake vs. UBS Warburg*, the court issued several opinions concerning e-discovery. One of the most significant decisions by the court underscored the need for a retention policy for e-information, as the court instructed the jury to assume that missing e-information was adverse to the defendant. The plaintiff obtained a $29 million verdict. The court set out that a party to litigation must observe the following with e-information:

--Place a litigation hold on potentially relevant e-information and notifying employees of that hold; oversee compliance with the litigation hold; and communicate with key employees how the e-information is stored and will be turned over.

The *Zumbulake* decision reinforces that emails should be thoughtfully written and that a document retention policy should be in place to deal with procedures when a delinquent account is being litigated or the vendor is defending a preference action.

In the case of Morgan Stanley, the investment bank and brokerage used 9/11 as the basis for failing to produce millions of emails in hundreds of arbitration claims. Morgan Stanley paid $15 million to settle a civil lawsuit with the Securities and Exchange Commission over failure to produce tens of thousands of emails. Bank of America was fined $10 million for failing to produce emails in a timely manner to the SEC.

These cases underscore the importance that emails have with litigation and disputes with customers, and that courts will impose sanctions, perhaps significant amounts, if companies fail to comply with managing and turning over emails.

E-Discovery Amendments

As a result of the court rulings and the explosion of email use, in December 2006, the Federal Rules of Civil Procedure were amended to take into account e-information. The key provisions that impact the credit department are:

-Definition of discoverable material includes all information that can be stored electronically, including Web–based email, instant messaging, voicemail, Blackberries and iPods;

-The parties must address early in the litigation the discovery of e-information and identify any disputes in providing the opposing party with the electronic information, including preserving the e-information;

-Provides that the requesting party to designate the form in which it wants e-stored information produced. The e-information that is difficult to access and produce is treated differently by the court;

-Safe Harbor provision allows that the court may not impose sanctions for failing to provide e-stored information lost as a result of routine document purging; and

-Failing to identify or preserve e-records may trigger sanctions, including fines and dismissal of the collection case.

When e-documents which have been requested have been destroyed, the court determines if the destroying party had an obligation to maintain the e-records. The court then determines whether the party acted with improper motives or intent in destroying the evidence. This is based on the spoliation of evidence doctrine that requires those who control important evidence keep it intact so that it can be reviewed by all. Courts take a case-by-case approach in dealing with e-information destruction. Given this, the credit department should consider an e-document retention policy that deals with retaining and destroying e-documents.

E-discovery imposes strict time limits on when e-information must be turned over. In litigation with a customer, the vendor would have approximately 30 days. In litigation with the government, such as the SEC, by contrast, the response may be as short as 48 hours.

These amendments addressing e-discovery mean that the credit department, with the assistance of the IT department or a third party, develop an effective management plan with the e-information in the credit department, from preservation of emails to production of emails to customers and bankruptcy trustees. The amendments underscore the importance that e-information is taking from the view of the court. The document retention policy needs to address the preservation of emails when a litigation hold is placed, as well as when e-information may be disposed without risk of destroying evidence and facing sanctions.

Email Policies and Procedures to Protect the Credit Department

Email has not only come to the forefront of the credit professional's life, but has also come to the forefront of the courts and litigants. Given this heightened interest by the courts in how emails are managed and the right the customer or bankruptcy trustee generally has with regards to turnover of emails, the credit professional needs to consider a retention policy that deals with disputed accounts and retaining emails until the dispute is resolved. Consideration should also be given to records management, including setting up a procedure for storing and purging e-information, including a records retention and destruction policy. With an e-retention policy in place, the credit professional is prepared to handle the discovery demands that may come with the disputed account or the preference demand.

COURT FINDS DEBTOR GUILTY OF BEING OVERLY OPTIMISTIC BUT NOT FRAUDULENT IN ITS PAYMENT PROMISES

(Continued from page 2)

the textile finisher's poor financial condition. The supplier asserted that it would not have allowed the Debtor to run up high account balances had they known the textile finisher had a negative net worth and operating losses, and that the textile finisher was making settlement payments to another creditor and loan payments to its shareholders. The supplier contended the Debtor had a duty to disclose these negative matters even though there was no inquiry for this information. Finally, the supplier asserted that even though the Debtor told the supplier that he would personally pay the balance due, he never had the intention of doing.

Section 523(a)(2)(A) excepts from discharge any debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud." To prevail under section 523 (a)(2)(A), a creditor must prove that the debtor made a false representation; at the time the debtor knew the representation was false; the debtor made the representation deliberately and intentionally with the intent and purpose of deceiving the creditor; the creditor justifiable relied on the representation; and the creditor sustained a loss and damage as a proximate result of the representation having been made.

Here, the Debtor must concede its representations that the textile finisher would pay the debt to the supplier were unquestionably false, and the supplier sustained a loss of $545,289.72 after the Debtor's representations turned out to be untrue. Nonetheless, the supplier failed to meet the other elements of section 523(a)(2)(A).

In reviewing the fourth element, the court noted that the supplier stopped selling to the textile finisher in 2000 because of the textile finisher's slow payment history. The Debtor further testified that the entire Alabama textile industry was slow from a credit standpoint, and several textile companies had gone out of business. All this was known to the supplier when it renewed credit sales to the textile finisher in March 2002. The supplier did not request any financial statements from the Debtor or the textile finisher. Based on these undisputed facts, the court finds that the supplier and its officers should have discounted the Debtor's optimistic projections of the textile finisher's ability to pay its debts.

The supplier took the position that under Alabama law an insolvent purchaser of goods on credit has a duty to disclose its insolvency to the seller-creditor, and if he fails to do so, he is guilty of fraud. The court, however, reasoned that a debtor's honest belief that a debt would be repaid in the future, even if in hindsight found to have been very unrealistic, negates any fraudulent intent. There was no substantial evidence to support a finding that the Debtor did not honestly believe that the textile finisher would eventually pay the supplier and other creditors. Although the textile finisher continued to repay shareholder loans and make settlement payments to another creditor, which might provide some motive for the Debtor to misrepresent the ability to pay its debts, there was no question raised regarding the legitimacy of the shareholder loans or the settlement indebtedness.

Because the supplier had resumed shipments without any request for financial information from the textile finisher, despite it was well aware of the troubled nature of the textile industry, and that several textile companies had gone out of business, and continued to supply greige goods even after the textile finisher again became delinquent in its payment, the court found that the evidence did not support a ruling that the Debtor's obligation to the supplier should be excepted from discharge under Section 523(a)(2)(A) of the Bankruptcy Code. As the court concluded, the Debtor "was guilty of being overly optimistic, but not of fraud."

RESURRECTING A GUARANTOR'S LIABILITY FOR PAYMENTS AVOIDED AND RECOVERED AS PREFERENTIAL TRANSFERS

(Continued from page 1)

The *Quality* court's holding is inline with other decisions on the issue. In fact, courts have uniformly held that a payment of a debt that is later set aside as an avoidable preference does not discharge a guarantor of his obligation to repay that debt, even without specific language in the guaranty reinstating the obligation in the event of a preference recovery.

Recently, the United States Court of Appeals for the Sixth Circuit addressed the issue. The Court of Appeals, in *Wallace Hardware Company, Inc. v. Bill Abrams*, found that as part of any recovery against the guarantors, the wholesaler could seek to recover the settlement payment that it had paid to retailer's bankruptcy trustee in settlement of trustee's preferential transfer claims against wholesaler. The Court of Appeals stated "courts have recognized, without regard to any special guaranty language, that guarantors must make good on their guaranties following avoidance of payments previously made by their principal debtors."

In the past, a vendor with an insider personal guaranty, could be subject to a year-long look-back period. Prior to the Reform Act of 2005, courts applied the Deprizio insider preference rule, which was established in and named after a chapter 7 bankruptcy filed by V.N. Deprizio Construction Co. In *Deprizio*, the court extended the one-year look-back period for insider preferences to transfers made to a non-insider creditor. The *Deprizio* rule permitted bankruptcy trustees to recover payments made by the debtor to banks or other non-insider creditors made within one year of the debtor's bankruptcy filing, if the debtor's debt to the non-insider was guarantied by an insider of the debtor.

As a result of criticism of the application of the *Deprizio* rule, Bankruptcy Reform Act of 2005 added a new subsection (i) to Section 547 of the Bankruptcy Code that provides that if the trustee avoids a transfer made to a non-insider between 90 days and one year before the debtor's bankruptcy filing, the transfer shall be considered avoided only with respect to the insider creditor. This Reform Act preference provision effectively limits the non-insider creditor's preference risk to a period of 90 days prior to the debtor's bankruptcy. Using the resurrection rule along with the changes under the Reform Act preference provision, vendors are assured the benefit of a guaranty without an increase in preference liability.

MISSPELLING DEBTOR'S NAME RESULTS IN CREDITOR'S LOSS

(Continued from page 3)

pealed, and the appellate court reversed, finding that the misspelled name was indeed seriously misleading. The vendor's purported lien was avoided.

Steps To Perfection

What would have made the vendor's claim secured requires an overview of the steps to create and perfect a security interest in a debtor's personal property. Article 9 of the UCC governs the perfection and priority of competing creditors on personal property. Personal property is property other than real estate, some fixtures, and certain intangible assets. To have a security interest in personal property, a vendor must go through a multi-stip process. The steps can be divided into creation of a security interest and perfection of the security interest.

Creation of the Security Interest

The three requirements that need to be met in the creation of a security interest are: (1) value must have been given by the debtor, (2) the debtor must have rights in the collateral it offers, and (3) the debtor must have signed a security agreement which contains a description of the collateral.

Traditionally, the security agreement is contained in a separate security instrument. However, some courts have ruled that a separate formal document entitled "security agreement" is not always necessary to satisfy the signed writing requirement. As long as there are documents, the reasoning goes, such as promissory notes or financing statements, the UCC's requirement for a security interest may be satisfied. These documents, examined collectively, must (1) adequately describe the collateral, (2) have the signature of the debtor, and (3) establish that a security interest was agreed upon by both parties. In this way, a security agreement may be found through a collective examination of various documents, none of which could, standing alone, be deemed a security agreement.

Perfection of the Security Interest

A vendor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the collateral. The main purpose in filing a financing statement is to guarantee that any third parties will have been notified of existing security interests in the collateral. The filing vendor thus takes priority over other creditors and has the right to take possession of and sell the collateral if the debtor defaults.

No Security Interest Where Financing Statement Is Seriously Misleading

A financing statement must give the correct name of the debtor, and signed by the debtor. A financing statement that misnames or misspells the debtor is nevertheless effective so long as the error is not "seriously misleading". However, if the financing statement misnames the debtor so much that it is misleading to a party searching for lien filings against the debtor, the filing has no effect and does not perfect the security interest. A filing officer uses the debtor's names to compose the index and subsequent parties use the index to find the filing. If the debtor's name is spelled incorrectly, the index may be wrong and subsequent creditors thus mislead.

In *Pankratz*, the appellate court found that the vendor leaving the "d" out of the debtor's name "Rodger" rendered the financing statement seriously misleading, as a lien search under the debtor's name spelled without the "d" would not turn up the vendor's lien filing.

The appellate court determined that the vendor's financing statement misspelling the debtor's name was "seriously misleading":

> "a financing statement 'is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading . . [i]f a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor . . . the name provided does not make the financing statement seriously misleading.' Under such circumstances a search using the edebtor's correct name would reveal the prior security interest of [the vendor] with the misspelled debtor's name and its financing statement would not be seriously misleading. However, the undisputed facts in this case establish that a search under the debtor's correct name using the filing office's standard search logic did not disclose Pankratz' financing statement with the debtor's misspelled name."

The creditor was able to unseat the vendor's unperfected lien.

Protecting Your Goods

As noted, a credit enhancement, whether in the form of a letter of credit, guarantee, deposit account or security interest, is welcomed by the credit professional as it can reduce or eliminate the credit risk, yet still make the sale. However, a vendor should heed the warning in *Pankratz* and ensure that the steps to create and perfect a security interest under Article 9 are strictly complied with, including properly spelling the customer's name to avoid a challenge to its security interest. A misspelled name in the financing statement, even off by one letter, may result in the vendor's loss.

THE CRISIS MANAGER— THE EXPERT IS THE ALLY IN CHAPTER 11 REORGANIZATION

(*Continued from page 2*)

CEO and the potential buyer's CFO finalized the contract without my involvement. I was subsequently provided a copy of the executed contract, from which I prepared the requisite cash forecast, which demonstrated that the secured lenders' position was not compromised, and I had the attorneys prepare the motion to extend the use of cash. It is normal that the Debtor has to prove to the Court that the creditors' secured interest in the cash is adequately protected.

In a meeting with the potential buyer's CFO, I informed him that the company would be able to extend the use of cash with the new contract. Our conversation turned to selected terms of the contract and after several rounds of questioning, it became clear to me that we were not looking at the same document. Upon comparing the potential buyer's copy of the executed contract with my own, I was incredulous to discover that they were not the same. I knew from experience that based on the potential buyer's copy of the executed contract, there was no way that the company would be granted an extension on the use of cash. Furthermore, what had taken place in changing the contract was outright fraud perpetrated by the President.. Upon further investigation of what had transpired, I was advised by one of the employees that he had been instructed by the Debtor's President to modify the executed contract and delete significant terms. I immediately called the attorneys and advised them of my findings.

Unfortunately for the company and its employees, the secured lender had the Court appoint a receiver and the company was closed down. While this anecdote is an extreme example of what happens when restructuring professionals are not involved in the process, creditors and other interested parties should not view the Debtor's professionals as the enemy, intending only to create obstructions or to deny their clients access to information. They should instead be perceived as participants, whose value in the process is derived, in part, by ensuring a transparent, smooth, and equitable emergence from bankruptcy.

By: Al Chavez, Phoenix Group Advisory Services, LLC

Phoenix Group Advisory Services, LLC specializes in providing professional financial and operational advisory services to companies throughout the Western Region of the U.S.

The Phoenix team is comprised of experts in mergers & acquisitions, business finance, operations, corporate restructuring and crisis management

KEEPING THE CREDIT AND FINANCIAL PROFESSIONAL INFORMED OF LEGAL DEVELOPMENTS

VISIT OUR WEBSITE @

www.bandblaw.com

The Trade Vendor Quarterly is distributed via E-Mail. ***The Trade Vendor Quarterly*** is a free publication prepared by the law firm of Blakeley & Blakeley LLP for clients and friends in the commercial credit and financial community. Please complete the following:

Representative to Receive Newsletter: ______________________________

Company Name: ______________________________

E-Mail Address: ______________________________

Telephone: ______________________________

Facsimile: ______________________________

Mailing Address: ______________________________

____

____

Others to Receive Newsletter: ______________________________

____

Please forward the information via:

E-mail: administrator@bandblaw.com

Fax: (949) 260-0613

Mail: Ms. Karen Sherwood
Blakeley & Blakeley LLP
1000 Quail Street, Suite 200
Newport Beach, California 92660