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ESCHEATMENT IN THE SPOTLIGHT AS STATE BUDGET DEFICITS SKYROCKET: WHAT A CREDIT EXECUTIVE NEEDS TO CONSIDER

Scott Blakeley
seb@bandblaw.com

The reported arrival of a recession in the U.S. reminds vendors of the financial challenges that customers face to be profitable in the coming quarters. States, too, are finding it more difficult to meet their budgets as a result of declines in corporate and sales tax revenue, increased foreclosures and weak consumer spending. Indeed, 25 states are projecting budget deficits for 2009. States are reacting to these shortfalls by considering massive budget cuts, including cuts. States are also considering untapped revenue sources to close the budget shortfalls. In this setting, escheatment revenue may be an untapped source for states. States may soon have a line item in their annual budgets for escheatment as a step to ease the budget crisis.

Escheatment revenue is appealing from the states' view as it does not require raising taxes, such as on tobacco and alcohol (and increasing lottery ticket sales). Given the budget crisis, many states are more aggressive in their collection of escheat dollars. Underscoring this, several private firms are working on behalf of states on a contingency fee basis to locate abandoned property that should have been turned over to the state.

How does a state's focus on collecting abandoned property affect the credit department? What is considered unclaimed property as it relates to the credit department assets? Does a credit balance qualify? What may be the consequence if the vendor declares the unclaimed property as income and applies it to the bottom line, as the vendor views it as a windfall to offset losses from unrelated delinquent accounts?

Escheatment Defined

Every state has legislation that requires companies to abandon unclaimed property, to the state after some vesting period. Escheatment includes all forms of properties, both tangible and intangible. Escheatment laws provide that the state may become the legal owner of abandoned property, based on the concept of state sovereignty.

Escheatable property that is within the credit department's accounting and reporting responsibilities includes rebates, credit memos, discounts and allowances, customer overpayments, misapplied payments and unapplied credits to the customer. The last activity with the account is measured from when the credit was issued.

Development of Escheatment Law

The origin of escheatment law dates

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MUST PREFERENCE ACTIONS BENEFIT UNSECURED CREDITORS OF A DEBTOR'S ESTATE?

Bradley Blakeley
bblakeley@bandblaw.com

The issue of whether preference actions must benefit unsecured creditors was addressed in the recent court order from the bankruptcy case of In re Brook Mays Music Company, Inc. In Brook Mays, the Texas Court required at the conversion of the case from Chapter 11 to Chapter 7 that the statutory trustee present a report regarding his analysis of the preference actions in the case before commencing such actions - all in an effort to stem what the court characterized as the "trustees and plan agents suing, with reckless abandon, every recipient of a transfer of property of the debtor that occurred within 90 days of the bankruptcy filing, with no consideration of obvious defenses, what makes economic sense, or the underlying policies of the preference laws which, since Elizabethan times, have always been about promoting equality of distribution among similarly situated creditors and deterring overreaching."

In the preliminary report, the trustee agreed not to sue: (a) any party who has entered into a court-approved settlement agreement that provided for a release of mutual claims; (b) any party in respect of payments received on an executory contract that was ultimately assumed; (c) certain taxing authorities who received payments in the 90-Day Preference Period in respect of claims that would have Section 507 priority status in the case had they gone unpaid; (d) any vendors who were fully secured or who

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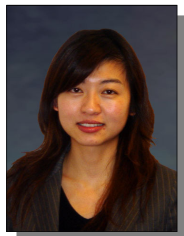
MULTINATIONAL INSOLVENCY: WHAT CREDIT PROFESSIONALS SHOULD KNOW ABOUT CHAPTER 15 OF THE BANKRUPTCY CODE AND A FOREIGN REPRESENTATIVE'S RIGHTS TO ADMINISTRATE A DEBTOR'S ASSETS IN THE UNITED STATES



Shirley Chen
schen@bandblaw.com

Chapter 15 of the Bankruptcy Code provides a powerful tool to a foreign creditor to seek satisfaction of a debtor's debts in the United States. One of the most important concerns of the local creditors, such as credit professionals in the United States, pertains to the payoff they may expect to receive on an account and the possibility of dividing up the local assets with other foreign creditors in a bankruptcy setting.

In broad summary, Chapter 15 provides a foreign representative in a foreign insolvency proceeding to interface with U.S. state and federal courts for the purposes of administrating a foreign debtor's assets. The state and federal courts are obligated to cooperate "to the maximum extent possible" with the foreign representative once a foreign proceeding has been "recognized" in the United States.

Although Chapter 15 is intended to provide effective mechanism for dealing with cases of multinational insolvency, the U.S. vendors are facing the risk of an "everyone-in" approach in which all of the debtor's worldwide creditors are invited to share the local assets of the debtor, thus minimizing the payoff a U.S. vendor may expect to receive.

A. Procedural Framework of Chapter 15

In In re Jonathan A. Loy, 380 B.R. 154 (Bkrtcy.E.D.Va. 2007), the court reviewed the procedural framework of Chapter 15 of the Bankruptcy Code within which an English trustee sought recognition in the United States in connection with an English insolvency proceeding.

Jonathan A. Loy (the "Debtor") is a British citizen residing in Hampton, Virginia. He is the owner of an undeveloped real property located in Hampton, Virginia (the "Hampton Property"). The Debtor made a Proposal for a Voluntary Arrangement with Creditors pursuant to the Insolvency Act of 1986 ("IVA") in England and was to sell certain property to help satisfy his debts, while retaining the Hampton Property. The Debtor eventually accumulated additional debt and was unable to meet the terms of the IVA. The Trustee filed a Default Petition and the English Court adjudicated the Debtor as a bankrupt, commenced a bankruptcy proceeding against the Debtor, and the Trustee is appointed in that proceeding (the "English Order").

The Trustee then filed a Petition for Recognition of Foreign Main Proceeding (the "Petition") in the United States. The Petition sought recognition of the English insolvency proceeding by the United States Bankruptcy Court, Eastern District of Virginia ("Bankruptcy Court).

The Trustee sought to seek the Hampton Property in an attempt to satisfy

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FROM THE PUBLISHER:

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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.bandblaw.com

SOLE PROPRIETOR ALLOWED TO DISCHARGE DEBTS AFTER TRANSFERRING ASSETS OF SOLE PROPRIETORSHIP TO SOLELY OWNED CORPORATONS

Ronald Clifford
rclifford@bandblaw.com

When a debtor files bankruptcy under Chapter 7, 11 or 13 of the U.S. Bankruptcy Code, the ability of an unsecured creditor to collect on their debt can prove to be an uphill battle. However, unsecured creditors may be in the situation where an individual debtor has committed fraud to avoid the reach of its unsecured creditors before the filing of a bankruptcy. In this case, the uphill battle begins to level out. The U.S. Bankruptcy Code provides that when such facts are present, an unsecured creditor may object to the discharge of debts by an individual debtor under § 727 of the U.S. Bankruptcy Code, or have their individual debts determined non-dischargeable under § 523 of the U.S. Bankruptcy Code. In a recent Wisconsin case, In re Jean M. Sundstrom, 374 B.R. 663 (7th Cir. 2007), the court applied this concept with an interesting outcome.

Essentially, the court refused to apply § 727 in the bankruptcy of an individual debtor that operated a business as a sole proprietor who transferred the assets of that business to a newly formed corporation that the debtor solely owned soon after a judgment against that business was obtained by an unsecured creditor. Although the assets were transferred between the businesses, the liabilities were not. After the transfer of assets, the debtor filed personal bankruptcy. The court held that the debtor did not act with intent to defraud their creditors in that the debtor was acting on a mistake of law. Without the intent on the part of the debtor to defraud its creditors, § 727 was not applicable.

The extension of unsecured credit carries with it a risk that a debtor could file a bankruptcy. To further complicate things, the analysis by a bankruptcy court of the facts of a case can be unpredictable. Elements like intent can be hard to prove, and holdings such

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SELLING ASSETS OUT OF BANKRUPTCY: TOP DOLLAR FOR VENDORS?

Scott Blakeley
seb@bandblaw.com

Chapter 11's are on the rise, as reflected in recent filings by Sharper Image and Lillian Vernon. These companies, and scores of others, are filing Chapter 11 not to reorganize their operations, pare debt and exit Chapter 11. Rather, many companies are filing Chapter 11 for the purpose of selling all of their assets free and clear of liens shortly after the Chapter 11 filing. These companies often have a company that is committed to purchasing the assets once the Chapter 11 is filed.

What does a sale of assets through a Chapter 11 mean for the credit executive's unpaid invoices? Must the buyer pay the vendor in full? If not, is there a minimum percentage that vendors must receive on account of their invoices? May vendors act collectively to maximize the purchase price of the assets, and therefore the distribution to unsecured creditors? What of selling the debtor on terms during the Chapter 11 and prior to a sale of assets, is that payment guaranteed? Is there a strategy that a vendor may employ to maximize payment on the prepetition claim in the face of a sale?

A. Maximizing Payment from an Insolvent Customer for Unsecured Creditors through a Sale

Some debtors may find their financial condition so dire that they are not able to continue to operate and meet their short term budget and cash demands. In this setting, a debtor may be pressed by its lender seeking to foreclose on the assets (including pursuing the personal guarantor). The company may find that a buyer (ideally multiple buyers creating an overbid situation) for all of the assets may be the only exit strategy in which unsecured creditors may receive a payment on their invoices. At this juncture the debtor may employ a financial consultant or investment banker to market the sale of the debtor's assets to the highest bidder. The debtor's assets are "shopped" to competitors of the debtor or a financial firm.

From the buyer's view, purchasing assets out of bankruptcy can advantageous as the assets may be undervalued. The buyer also gets the protection of buying assets free and clear of liens. The buyer may also eliminate future claims through successor liability theory. The buyer can also purchase leases and contracts through an assignment provision of the Bankruptcy Code.

To vendors, a bankruptcy sale provides opportunities and risks. Vendors must be mindful that the debtor's principals may try and extract special concessions through the sale process to the detriment of vendors. But the sale may provide vendors the greatest opportunity for a distribution from the insolvent customer.

B. The Sale Process

1. Debtor's 363 Motion

In a Chapter 11, a sale of substantially all of the debtor's assets requires bankruptcy court approval under section 363 of the Bankruptcy Code. The debtor requests court approval through a motion which sets forth the assets being sold and that the assets are being sold free of liens, which attach to the sale proceeds.

2. Creditors Right to Complain

The debtor must give notice to all creditor of the sale of assets. The notice of sale sets forth the terms of sale, including price. The notice may provide a range of distribution to unsecured creditors, but often that is not disclosed. The notice sets forth the time period in which the creditor must object.

3. The Bankruptcy Court's Approval

The bankruptcy court will consider the debtor's motion to sell and creditor objections. At this hearing, the court will consider over bids, and may hold an auction of the assets. Where the bidders offer payment terms, the court will consider the bidders' ability to honor the terms and financial wherewithal. The court will decide the successful bidder.

4. The Break Up Fee to Attract Bidders

Generally, the bankruptcy court must approve the sale of assets through a competitive bidding process. The initial bidder, labeled the stalking horse, will insist on certain protections. The key protection to the initial bidder will be a breakup fee for out of pocket costs and fees. In addition, the debtor will also offer other concessions to the initial bidder, such as initial overbid amounts, over bid thresholds and requirements that over bidders prove their ability to purchase. The bankruptcy court must approve the bidding procedures motion, subject to creditor objections.

5. Alternatives to a 363 Sale

When the recent Chapter 11 filings show, a debtor and the initial bidder often file the motion to sell substantially all of the assets in the opening days or weeks of the Chapter 11. However, on occasion, a bankruptcy court or its creditors may require that the asset sale proceed only through a plan of reorganization. In this setting, the sale process proceeds more slowly and creditors have a greater opportunity to investigate the value of assets and purchase price. However, an initial bidder may push back from a sale through a plan as it too time consuming. The bidder may insist that the sale close within a specific period, often within 30 days. The bankruptcy court will decide whether the sale may proceed through a motion or plan of reorganization.

6. Assumption and Assignment of Executory Contracts and Leases

Through the sale motion, the debtor may also assign its interest in the leases and executory contracts, even if the lease or contract bars assignment. Through the assignment, the debtor must cure delinquent amounts owing the holders to the leases and executory contracts. This provision encourages the initial bidder to insist the debtor file Chapter 11, as such assignments cannot be achieved outside of a bankruptcy filing.

Consider Opportunities and Risks with Sale

Both Chapter 11's and asset sales are on the rise. Vendors have the opportunity to maximize on their prepetition claims with a sale and overbid. However, the vendor must be vigilant during the sale process as there are competing interests throughout the sale. Vendors may best protect their interests by serving on a creditors' committee, which is the primary negotiating party on behalf of unsecured creditors. The creditors' committee may seek a competing bid that will maximize the value for creditors.

VENDORS WITH STATE AND FEDERAL LAW LIEN AND PRIORITY CLAIM RIGHTS MUST BE VIGILIANT WHEN CUSTOMER FILES BANKRUPTCY

Scott Blakeley
seb@bandblaw.com

What can happen with your special creditor protections that the federal government or state legislature have enacted, such as PACA lien rights, mechanic lien rights, even reclamation rights under the Uniform Commercial Code, when your customer files chapter 11? A vendor may assume that its federal or state law lien or claim rights are fully preserved, even should a customer file chapter 11. However, a recent bankruptcy court ruling, considered below, reminds vendors that they must be vigilant during a chapter 11 proceeding to preserve these special lien and administrative claim rights or risk losing them.

Lien Rights and Priority Claims Must be Preserved

An overview of some federal and state creditor legislation is considered.

1. The PACA Lien

The PACA statute is intended to protect sellers of perishable commodities from unfair practices by buyers. PACA requires that buyers make full payment promptly, and does not permit suppliers to qualify for PACA protection if they ship on open account greater than 10 days. That time period is expanded to 30 days if the open account sale is in writing. The greatest protection offered suppliers under PACA is the creation of a trust for the benefit of the supplier where the buyer fails to pay, which trust also extends to the proceeds from the sale of the goods. The supplier perfects its trust rights by sending notice to the buyer and the Secretary of Agricultural after payment is due. Failure to send notice to the buyer and the Secretary of Agricultural results in loss of the statutory trust.

2. Mechanic's Lien Law

Contractors, subs and material suppliers (among others) who contribute services or materials to a construction project are entitled to assert mechanic's liens. The supplier must give preliminary notices to the property owner and others depending on the jurisdiction. The supplier records a claim of lien with the county recorder's office, and the supplier may then initiate a legal proceeding by filing a complaint for foreclosure, and records a notice of lis pendens. The lien attaches to property immediately when the supplier provided the labor or materials.

3. Reclamation Law

Reclamation is the right of a seller of goods to recover possession of them delivered to an insolvent buyer, and the seller is unable to retrieve goods or stop them in transit. If the customer has not filed bankruptcy, reclamation is governed by the Uniform Commercial Code, section 2-702. Under the UCC, the seller may reclaim goods provided a demand is made within ten days of receipt.

Should the customer file bankruptcy, section 546 of the Bankruptcy Code controls. Once a bankruptcy is filed, a vendor can assert a reclamation demand for goods received within 45 days of the bankruptcy filing. Vendors which ship goods within 20 days of the debtor filing bankruptcy no longer have to establish the validity of their reclamation claims, as the reclamation claim is given administrative priority.

4. Conflict with the Bankruptcy Code

The Bankruptcy Code is a federal law that may preempt state and other federal laws in certain settings. While the Bankruptcy Code is to leave intact a creditor's state law rights where there is no conflict, where there is such a conflict, the Bankruptcy Code prevails. This means that those conflicts of laws may jeopardize a vendor's right for payment.

Federal Bankruptcy Law May Conflict with Vendor-Friendly Legislation, Requiring Vendor to Act

These creditor rights laws appear to give vendors special protection, even should the customer file bankruptcy. However, in a chapter 11 proceeding, the creditor may find that its right to payment (or collateral) may be lost. A recent bankruptcy court decision considers these potential conflicting laws.

5. Conflict of Laws in Action

In *Brown & Cole Stores* decision, the debtor, a specialty retail grocery chain, filed chapter 11. A vendor that had supplied produce asserted a PACA claim for recent deliveries. The debtor filed a motion in the bankruptcy court for an order approving procedures for administering PACA claims, which was approved. The vendor filed a motion for the immediate turnover of PACA assets, which the court denied. Thereafter, the debtor filed a motion in the bankruptcy court for authority to pay the balance remaining in the PACA trust to certain lenders, which was approved. From the vendor's view, this worked an injustice as the lenders were taking the vendor's cash proceeds from the sale of its produce. The vendor requested the district court overturn the bankruptcy court's order for turnover of PACA assets.

The district court first considered whether it was the proper court to even consider the vendor's request, and ruled that it was not. In its motion, the vendor stated that it did not present the motion for stay to the bankruptcy court, but rather went directly to the district court as vendor viewed such efforts as futile.

The district court disagreed, finding that the order authorizing payment to the lenders provided that "the Debtor is authorized to pay the balance remaining in its PACA Trust Account on its DIP Loan after ten (10) calendar days following the date of entry of this Order unless a Notice of Appeal is filed and the Court enters an Order granting a stay pending appeal." The district court found no basis for the vendor not presenting the motion first with the bankruptcy court.

Lessons Learned

The *Brown & Cole Stores* decision reminds vendors that they need to be vigilant when their customer files chapter 11, which may require they take action to preserve lien rights or priority claims. While counsel for the vendor may be integral to this process, the credit executive can also play a key role in preserving the lien or claim by monitoring the chapter 11 through the bankruptcy court's automated docketing system, Pacer, and reviewing the pleadings filed, including any motion involving financing, use of cash collateral and proposals to pay secured creditors. Likewise the vendor may file a request for special notice. While the vendor may believe they have sufficient legal protections spelled out in state or federal lien law or claims, the *Brown & Cole Stores* reminds vendors that action on their part may be required.

ESCHEATMENT IN THE SPOTLIGHT AS STATE BUDGET DEFICITS SKYROCKET: WHAT A CREDIT EXECUTIVE NEEDS TO CONSIDER

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back to British law, where abandoned land was returned to the king. The states within the United States have followed this principle, broadening what qualifies as abandoned property.

Uniform Disposition of Unclaimed Property Act

With the growing popularity of state unclaimed property statutes as a new source of state revenue in the 1950's, uniformity of such laws became a necessity, as controversies between states over conflicting claims to property developed. For example, if a corporation abandons credits it holds based on a trade relationship with a customer, several states might attempt to claim custody of the credits. The credits could be covered under the law of the state where the company was incorporated, or the state where the corporate headquarters was located. In addition, any state that was doing significant business with the corporation might claim the property.

In 1954, the Uniform Disposition of Unclaimed Property Act (the "Uniform Act") was introduced to unify the state statutory scheme of escheatment. The Uniform Act was amended in 1966 and 1981. The Uniform Act attempts to prevent multiple sate claims for abandoned property by designating the last known address of the owner as the basic test of jurisdiction. Thus, under the Uniform Act, if two states claim the same property, the law of the state of the last known address of the owner governs.

Generally, if the property is considered to have a situs within the state, it is subject to escheat. The Uniform Act establishes a period for a presumption of abandonment for most types of property. Forty two states (including California, New York, Texas, and Florida) and the District of Columbia have enacted some version of the Uniform Act.

Delaware receives a significant portion of escheated property, notwithstanding that its small population. This is because a large percentage of corporations incorporate in Delaware. Under the escheat laws, a party forwards the abandoned property to the company's state of incorporation, where the address of the owner can no longer be located.

States Interest in Escheatment

States are now collecting billions of dollars a year from companies by enforcing their escheatment laws. While the escheatment laws are intended to return property to their rightful owner, it has become a way for states to increase revenue without increasing taxes.

States are especially attracted to escheatable property as they are looking to these unclaimed assets to cover their expenses. Vendors are now required businesses to turn over abandoned property more quickly. States have also strengthened enforcement by hiring private auditors to examine the vendor's compliance, who may be employed on a contingency basis.

By way of example of the windfall inuring to states under the escheatment laws, the Wall Street Journal recently reported that California holds more than $5 billion in unclaimed property, while collectively states hold $35 billion in unclaimed property. Each year states are increasing their abandoned property take, collecting $5.1 billion in 2006, while but three years before $3.6 billion was collected.

Risks of Not Escheating

Most states require businesses to review their records to determine whether any property has been unclaimed for the dormancy period and to submit an annual report. State escheat statutes have harsh provisions for parties that fail to timely report or turnover unclaimed property. In addition to interest that runs from the period that the property should have been turned over, a state may assess fines, penalties and damages.

Escheatment Audit

A state generally enforces its escheatment law through an audit. Audits are usually handled by the state treasurer's office or controller, although states are employing third parties to assist in collecting escheatable dollars. The scope of the audit usually goes back several years. The auditors usually request the following: (1) chart of accounts; (2) general ledger/ trial balance; (3) annual report; (4) journal entries; (5) bank reconciliations; and (6) accounting policies.

Under Delaware's escheatment program, an investigation was undertaken as to whether companies incorporated in Delaware were submitting required annual reports on unclaimed property. Only a fraction were doing so. Delaware hired outside auditors and was able to double collections of escheatable property to $365 million in five years.

With escheatment, Delaware auditors, for example, ask for documentation going back to the early 1980s; if documents aren't available, the auditors use a sampling of recent records to estimate how much a company owes the state.

Steps to Protect Against Escheatment Claims

A credit executive should develop a game plan, and consider the following:

Step One: Determine the Situation

- –Review past compliance. Has the company every reported unclaimed property? If so, what, when and where?
- –Has the company ever been subject to an escheatment audit? If so, what were the results?
- –Are there any subsidiaries to be included?
- –Has the company made any recent acquisitions that should be included?

Step Two: Determine Eligible Property

- –Does your company have some of the property types covered by most states? For the credit professional these include:
  - cash,
  - credits, including rebates, discounts and allowances
  - overpayments and misapplied payments
- –What states are represented among the names and addresses to be reported?
- –If this is an initial filing? What about years that may not be on the books?

Step Three: Perform the Due Diligence

- –What due diligence is required by the state? Specifically, focus on:
  - the minimum dollar amount,
  - timing, method and
  - content.

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ESCHEATMENT IN THE SPOTLIGHT AS STATE BUDGET DEFICITS SKYROCKET: WHAT A CREDIT EXECUTIVE NEEDS TO CONSIDER

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–Develop a strategy to minimize unclaimed property liability and review potentially reportable items.
–Prepare the due diligence letter. This should include:
- response deadline
- identification number and amount
- property type/reason
- instructions for claiming

Step Four: Prepare Reports and Remittances
–Identify due dates for states
–Prepare a cover sheet with signature
–Use the proper media, paper, diskette, etc.
–Use the proper report format
–Include the remittance, which might be a check, wire transfer, etc.

Step Five: Filing Reports and Remittances
–File on time to avoid penalties and interest
–If you get an extension, get it in writing. Only some states will grant them.

Step Six: Follow up and Reconcilement
–Reconcile general ledger to detail
–Reconcile paid items to appropriate accounts/divisions
–File any necessary holder reimbursement claims with the states
–Establish a filing system for reports and work papers.

Credit executives may also look to the following web site for guidance: National Association of Unclaimed Property Administrators: www.unclaimed.org

Turning Over the Property

If your company decides to turnover the unclaimed property to the state, most state statutes provide that the vendor should turn the property over to the state controller. Most legislation requires the vendor to make reasonable efforts to notify the owner of the property by mail that the owners property will escheat to the state. The notice should be mailed not less than six months before the property is to be turned over to the state controller.

Depending upon the nature of the property, all unclaimed property should either be delivered to the State Treasurer or Controller. When the unclaimed property is cash, delivery is made to the State Treasury; all other types of personal property go to the Controller.

The party delivering the property is relieved and held harmless by the state from all claims regarding the property. No action or lawsuit may be maintained against the holder of the property.

Prior to delivery, the holder must furnish notice to the Controller. At a minimum, notice must include the amount of cash, or nature or description of other personal property; the name and last known address of the person entitled to the property; and reference to a specific statutory provision under which the property is being transmitted.

i. Scott Blakeley, of Blakeley & Blakeley LLP, practices creditors' rights and bankruptcy law. He can be reached at seb@bandblaw.com.

MUST PREFERENCE ACTIONS BENEFIT UNSECURED CREDITORS OF A DEBTOR'S ESTATE?

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only received payments during the 90-Day Preference Period from a trust or other third -party funds; and (e) any vendors who received transfers totaling less than $10,000 during the 90-Day Preference Period. The court also required that the trustee not pursue any vendor for any payment relating to goods shipped within 20 days prior to the filing which would give rise to a 20 Day Administrative Claim under Section 503(b)(9) of the Bankruptcy Code. If a vendor is compelled to return a pre-petition payment for goods received by the Debtor 20 days prior to bankruptcy filing, the 20 day invoices would now be unpaid, which in turn would result in a 20 Day Administrative Claim. These limitations produced big dividends – reducing the potential preference from more than 1400 claims to 189 potential claims.

In its order approving the preliminary report, the court took the opportunity to address its concern about preference litigation being waged in a context in which there is little chance that unsecured creditors are going to realize any benefit. The court noted that the lender had a large deficiency claim, for which it obtained a superpriority administrative claim. The court observed that, after payment of chapter 7 and 11 administrative expense claims, there would be no distribution to unsecured creditors. The court expressed that it had "grave concern whether it makes sense (or is consistent with preference policy) to pursue preference litigation in such a context." However, the court recognized that there was nothing the Bankruptcy Code that explicitly requires that a preference action benefit unsecured creditors and refrained from imposing such condition out of concern that such a blanket ruling could result in mischief by a debtor in certain cases.

From a creditor's perspective, in addition to asserting traditional defenses, the creditor should apply the "benefit to the estate test" as expressed in the Brook Mays order to determine who will ultimately receive payment in the event the creditor is forced to return all or some of the alleged preferential transfers. If only administrative claims will be paid, the creditor should use employ the Brook Mays order to support their position that the preference litigation is not warranted. At a minimum, the creditor should be entitled to propound discovery concerning who will benefit from prosecution of the actions and draw their court's attention to the issue of improper preference litigation.

MULTINATIONAL INSOLVENCY

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the Debtor's debts in the English bankruptcy proceeding. The Trustee filed a Memorandum of Lis Pendens in the Circuit Court for the City of Hampton, Virginia, against the Hampton Property, prior to filing the Petition for recognition in the Bankruptcy Court

B. Recognition of the Foreign Proceeding

Chapter 15 of the Bankruptcy Code allows a foreign representative of a foreign bankruptcy proceeding to apply for recognition of that foreign proceeding in the United States. If the foreign proceeding qualifies for Chapter 15 recognition, "the foreign representative gains the capacity to sue and be sued in the United States courts and the authority to apply directly to a court in the United States for appropriate relief, and that all courts in the United States must grant comity or cooperation to the foreign representative." 11 U.S.C. section 1509(b) (2007).

In this case, the Bankruptcy Court was satisfied that the Trustee met the definition of a foreign representative and the English proceeding is a foreign proceeding, as the English Order declared a bankruptcy in the foreign proceeding and the Trustee was appointed in the matter.

C. Determine Whether the Foreign Proceeding is a Foreign "Main" Proceeding

The Court must also determine whether the English insolvency proceeding is a "main" or "nonmain" proceeding." Chapter 15 defines foreign main proceeding as a "foreign proceeding pending in the country where the debtor has the center of its main interest."

The Bankruptcy Court looked at several factors before concluding that the English proceeding is a foreign "main" proceeding, as the Debtor's habitual residence is in United Kingdom. Furthermore, almost all of the Debtor's creditors are located in the United Kingdom and the Debtor's bankruptcy proceeding was governed by the English law. Accordingly, the English proceeding is qualifies as a foreign "main" proceeding.

D. Must a Court First Grant Foreign Proceeding Recognition Before the Foreign Representative Can Take Any Action Outside of the Bankruptcy Court?

Section 1509 of the Bankruptcy Code imposes a requirement on the foreign representative that he must first obtain foreign proceeding recognition before enlisting the comity or cooperation of a court of the Unites States. However, if a foreign representative does not seek to involve a court's comity or cooperation, he need not first seek foreign proceeding recognition.

Even if a foreign representative does seek to involve a court's comity or cooperation, section 1509(f) contains an exception in that a foreign representative is not required to obtain Bankruptcy Court's recognition in order to sue in a state court to collect or recover on a claim that is the property of the debtor.

Here, the Bankruptcy Court found that the filing of the lis pendens in a circuit court is a ministerial task and has not implicated the comity or cooperation of the Circuit Court of the City of Hampton (the "Circuit Court"). The Trustee does not need to seek recognition as the filing of the lis pendens does not involve a court's comity or cooperation.

Even if the filing of the lis pendens requires the comity or cooperation of the Circuit Court, the Trustee is not required to first obtain recognition as the exception to section 1509 applies to the Trustee's action in this case.

As the Trustee became the owner of the Debtor's interest in the property, the filing of lis pendens was the Trustee's first step to "suing in a court in the United States to collect or recover a claim which is the property of the debtor." 11 U.S.C. section 1509(f) (2007). Therefore, even if the filing of the lis pendens could be considered an act that requires the comity or cooperation of a court, it falls into the exception in that the Trustee was attempted to recover on the Debtor's property and the collection in the state court does not require a prior recognition by the Bankruptcy Court.

E. Conclusion

The ruling in In re Roy is an attempt to provide a procedural framework of Chapter 15 within which a foreign representative can interface with U.S. state and federal courts for the purposes of administrating the debtor's assets. Chapter 15 provides a powerful tool to a foreign representative to seek satisfaction of a foreign debtors' debts in the United States.

However, this tool increases a credit professional's risk pertaining to the payoff he may expect to receive on an account. As Chapter 15 allows a foreign representative to collect or recover upon a debtor's property in a state court without first obtaining a formal recognition of the foreign proceeding in the bankruptcy court, the burden is now on the U.S. credit professionals to "bullet-proof" the collection on the debtor's property in order to minimizing the risk of reduced recovery when other foreign representatives are now able to reach into debtor's U.S. local assets in a multinational insolvency setting.

SELLING ASSETS OUT OF BANKRUPTCY: TOP DOLLAR FOR VENDORS?

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as this one can make the task of proving such elements even harder. This case is proof of the incentive for creditors that extend unsecured credit to familiarize themselves with, and to take advantage of credit enhancements to aid in protecting these extensions of credit from falling victim to the sometimes unpredictability of the bankruptcy process.

Court's Analysis

In In re Jean M. Sundstrom, an unsecured creditor brought an adversary action in the bankruptcy of an individual debtor under § 727(a)(2)(A) of the U.S. Bankruptcy Code. The creditor was a franchisor that entered into a franchise agreement with the debtor. The debtor ran the franchise, and entered the franchise contract, as a sole proprietor. The debtor financed the agreement with the creditor with two promissory notes. After some time, the debtor defaulted on the promissory notes with the creditor at which point the creditor obtained a judgment against the debtor for the debt of the sole proprietorship business. Two and a half months after the entry of the judgment against the debtor, the debtor transferred all of the assets of the sole proprietorship to a newly formed corporation in which the debtor was the sole owner. The liabilities of the sole proprietorship were not assumed by the newly formed corporation. Some months after formation of the new corporation and the transfer of the assets of the sole proprietorship to the corporation, the debtor filed personal bankruptcy. The creditor's debt was listed as one of the debts sought to be discharged in the bankruptcy.

Legal Standard and Application

There are two commonly used doctrines in which an unsecured creditor can seek to challenge the discharge of debts by an individual debtor.

Section 523

Under § 523 of the U.S. Bankruptcy Code, an unsecured creditor seeks to have their debt determined non-dischargeable to the extent that the debt was obtained by false pretenses, a false representation, or actual fraud, or when there is the use of a statement in writing by the debtor that is materially false, respecting the debtor's or an insider's financial condition, on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied and that the debtor caused to be made or published with the intent to deceive. It is important to note that under § 523 of the U.S. Bankruptcy Code, the creditor asserting this section is seeking to have only its debt discharged.

Section 727

Under § 727 of the U.S. Bankruptcy Code, an unsecured creditor seeks to object to the discharge of the individual debtor's debt when the debtor, with intent to hinder, delay or defraud a creditor has transferred, removed, destroyed, mutilated, or concealed property of the debtor, within one year before the date of the filing of the bankruptcy petition, or the debtor knowingly and fraudulently made a false oath or account, presented or used a false claim. Important here is that there is an objection to the dischargeability of all debts.

Application of 727 by Court

In the case at issue, the creditor objected to discharge of the debtor's debts pursuant to § 727 of the U.S. Bankruptcy Code in that the transfer of the assets of the sole proprietorship into the corporation, which sheltered the assets from the effect of the bankruptcy, was done with the intent to hinder, delay or defraud the creditors. Essentially the creditor argued that after it received a judgment for its debt against the debtor, the debtor transferred the assets of the sole proprietorship to the solely owned corporation to prevent having to pay the debt with those assets.

The court found that the time period required for application of § 727 was met in that the transfer of the assets from the sole proprietorship to the newly formed corporation was done within one year of the filing of the petition. An issue was whether there was truly a transfer, as required under § 727, in that the assets were essentially going from a sole proprietorship that the debtor owned, to a corporation that was solely owned by the debtor. The court held that "the transfer of ownership, even without diminution of assets available to a creditor, and certainly without loss of control by the debtor, appears to meet the expansive bankruptcy definition of 'transfer.'"

The only issue that was left for the court to determine that § 727 applied to the transfer was whether or not there was intent on the part of the debtor to defraud the creditors. The court held that intent can be hard to prove, but that circumstantial evidence could be used to find an inference of intent. Specifically, the court held that an analysis of the totality of the circumstances is used to determine intent. The court found that in this case the debtor thought that what they were doing was not legally wrong. The court held that this honest mistake in interpreting the law did not rise to the level of intent to defraud required under § 727, and therefore allowed the discharge of all debt.

Conclusion – What Can a Vendor Take Away From This Case?

This case highlights the sometimes unpredictability of the bankruptcy courts. One could easily view the totality of the circumstances in this case to meet the necessary intent element required to have application of § 727. An important lesson for vendors extending credit to debtors is that many situations can enter the credit relationship that are fairly unforeseeable. In this case, the creditor certainly never foresaw the debtor transferring the assets of the sole proprietorship to a corporation that she solely owned, and then filing personal bankruptcy, which in turn discharged its debt under the sole proprietorship while shielding the assets. Even more unforeseeable was the court's finding that the intent to defraud was lacking due to the debtor's mistake of law. This unforeseeability only highlights the importance of taking advantage of credit enhancements such as letters of credit, credit insurance, put options and certificates of deposit to reduce the risk of not only default of the debt, but the potential for the unknown after default to collect.

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Please forward the information via:

E-mail: mbush@bandblaw.com

Fax: (949) 260-0613

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