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

COMMERCIAL CREDIT AND THE RECESSION:

COLLECTING ON YOUR DELINQUENT ACCOUNT (AND PRESERVING THE TRADE RELATIONSHIP) USING A REPAYMENT AGREEMENT

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Chapter 11 filings and out-of-court workouts and liquidations are on the rise as a result of a downturn in the economy. Companies that are weathering the downturn and are able to avoid more formal restructurings, may find themselves failing to honor their trade terms with vendors because of the freeze in the credit markets and downturn in customer demand.

However, in a recessionary economy, the credit professional cannot merely cut off credit when a customer fails to honor its credit terms. The focus of the credit professional is no longer merely collection alternatives as a substitute customer can be found in a robust economy. Rather, the credit professional must evaluate, with the assistance of sales and management, credit risk for future sales even where a customer has past due invoices.

In this recessionary setting, the credit professional must create the documents that create the greatest leverage for payment on the delinquent account and minimize any later disputes as to balance owing, pay down and payment method. Rescheduling the past due invoices into a formal repayment agreement may be an essential document for the credit professional for payment on the past due invoices and the expectation for future sales in a recessionary economy.

A. The Repayment Agreement and Due Diligence

In assessing the prospects of a repayment agreement as a method to cure the delinquent account, as opposed to litigation alternatives, the vendor must determine the customer's willingness, ability and trustworthiness to pay on the past due balance, and future need for the product or service. Has the customer sought out a competitor of the vendor to replace it? Has the customer become untrustworthy, for example, by placing an unusually large order and in a hindsight learning the debtor did have the cash flow to pay?

Some ways in which the vendor can determine whether a customer may commit to a repayment agreement and has the financial wherewithal to repay the debt: request financial projections that support the customer can honor the repayment agreement and future sales. If the customer is a business organization that is privately held and takes the position that financial information is not shared, the vendor can offer a confi-

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Creditors seeking to collect on a delinquent account often find themselves waiting six months or sometimes much more for entry of a judgment before they can collect. However, in most states, creditors can take advantage of the state's prejudgment remedies to elevate their status from an unsecured creditor to secured creditor in the interim while they seek their judgment.

Attachment is a prejudgment remedy that allows a creditor to assert a lien on the debtor's assets until final adjudication of the claim sued upon. To obtain a writ of attachment, the creditor must follow statutory guidelines in applying for the attachment and establish a prima facie claim, and the court is required to make a preliminary determination of the merits of the dispute. This will usually cause the debtor to re-evaluate its position, facilitating early settlement of the case. It will also give the creditor a preview of the debtor's potential defenses to the case.

There are risks to consider. Attaching a debtor's assets may precipitate bankruptcy. If this occurs within 90 days after the writ is levied, the attachment lien terminates automatically and the creditor is relegated to unsecured status. Also, if the creditor ultimately loses the claim on which the attachment was based, it can be sued for wrongful attachment.

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USE STRONG ARM POWERS AND LIEN AVOIDANCE AS A METHOD OF OBTAINING ASSETS

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For trade vendors that deliver goods to customers on credit, there is always the fear that the customer will not make good on the credit sale, or even worse, that the customer will file bankruptcy making collection on the credit sale an uphill battle. Trade vendors country-wide have dealt with a customer in bankruptcy, and many times find little value in pursuing payment after the bankruptcy petition is filed. This is understandable, especially in today's economic climate, where many companies are simply in bankruptcy while they liquidate their assets, which in most cases results in little to no value for trade creditors once the dust of bankruptcy settles.

However, trade vendors should spend the time to analyze certain issues when a customer files for bankruptcy rather than immediately taking the position that filing a proof of claim and waiting for distribution, if any, is the best option. Besides the bankruptcy version of reclamation, trade vendors should always consider strong arm powers and lien avoidance provided under the Bankruptcy Code. Trade vendors may find that the application of these bankruptcy remedies in a bankruptcy case makes assets available to pay, at least in part, their bankruptcy claims.

It is common in bankruptcy cases for there to be a secured creditor that essentially has a security interest in most, if not all, of the debtor's property. Under the Bankruptcy Code's priority scheme, the secured creditors are paid prior to any unsecured creditors. Of course, as luck would have it, most trade vendors are unsecured creditors in the bankruptcy setting. In many cases there is very little money left for unsecured creditors once the secured creditor is paid by the bankruptcy estate. The task then becomes challenging the secured creditor's status as a secured creditor.

The strong arm powers under the Bankruptcy Code allow the avoidance of a creditor's pre-petition secured lien when that lien was not properly perfected prior to the filing of the bankruptcy petition. The bankruptcy courts look to state law to determine if a lien is perfected or not. Should the lien not be perfected under state law prior to the filing of the bankruptcy petition, the trustee, debtor-in-possession, and possibly the creditor's committee may unseat that lien, thereby transforming the secured creditor into an unsecured creditor in the bankruptcy case.

In a leading case, *Rogan v. America's Wholesale Lender*, a secured creditor failed to properly perfect its secured lien, a mortgage, under Kentucky law prior to the filing of a bankruptcy petition. 2004 WL 771484 (6th Cir. 2004). Kentucky law requires a notary's acknowledgment on the mortgage instrument being filed. Although the mortgage instrument was filed by the secured creditor, the required notary acknowledgement was not completed. The bankruptcy court therefore held that the lien was avoidable. Even though the mortgage instrument was filed in the correct office, and anyone could have viewed the instrument with little research, the failure to properly file the mortgage instrument under Kentucky law allows that security lien to be avoided in the bankruptcy setting.

In another case involving a secured

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FROM THE PUBLISHER:

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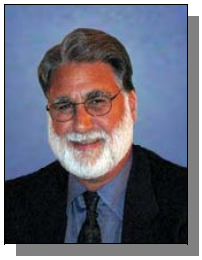
Guest Column

EFFECTIVE MEETINGS ARE NO ACCIDENT, INEFFECTIVE MEETINGS ARE A TRAIN WRECK



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Today meetings are an essential part of our every day business lives. With increased workload, less resources and critical decisions taking a front seat no one has much time to waste. That is why it is more important than ever to avoid unnecessary meetings. The meetings that are necessary must be focused and worth the cost of attendance.

Effective meetings get problems solved and facilitate the communication of critical issues. Ideally participants are individuals who need to be there. They have a need to be aware of points covered, are a valuable contributor and will be responsible for follow-up actions decided upon in the meeting.

Unfortunately many times this is not the case. Key individuals are late or fail to attend. Some attendees fail to participate or continually change the subject, attack others or dwell on irrelevant detail. Many people take the time spent in meetings as a necessary evil. We all go to so many meetings we sort of float through, feeling somewhat victimized by the process. How many times have you just wondered why you were at a meeting in the first place?

There is something you can do about it. The key is to realize that meetings are best accomplished with pre-planning and attention to each stage of the meeting process. Yes, meeting process. There is much more to an effective meeting than just showing up.

An effective meeting has four important phases. Each of the following must be managed by the meeting organizer to gain the true "return on investment" your company deserves:

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DOING BUSINESS AS: INFORMATION PROTECTS YOUR COMPANY DURING A RECESSION

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Suppliers and vendors in all areas of business are being hit with delinquencies and fraudulent customers. In today's troubled economic times, when deals go awry, information about a customer can be the key to prevent fraud or assist in collection of payment.

Information is Gold

A surge in delinquencies has shown that many transactions are not being honored. A company supplying goods, even in cash transactions, can be susceptible to nonpayment or fraud. Much of the fraud or difficulty in collection of payment can be avoided by a company obtaining information about their customer prior to engaging in business. To prevent fraud and difficulty in collection of payment, a few simple questions can be added to the standard credit application or supply contract to determine who a supplier is truly engaging in business with.

A common staple in the industry of vendors and suppliers is often a credit application or supply contract. Credit applications allow vendors to ship product on credit to their customers without requiring immediate payment. However, supplying goods on credit in a recession is ripe for fraudulent companies to take advantage of trusting business partners. A few precautionary questions in a credit application can go a long way in eliciting crucial information that will protect suppliers from unsavory customers and assist in collection efforts when a customer refuses to pay.

Documenting the Sale - Obtaining Business Name and Form

A set of questions in a credit application referring to a potential customer's registered and fictitious business names and registration numbers can protect a supplier from fraud, collection costs, and potential litigation.

To legally transact business in a state, a business must be registered with their Secretary of State office. It is always good policy to require customers to state on the credit application the state of incorporation and their registered name. However, often a company will start doing business under a new business name, also known as a fictitious business name, or DBA (doing business as). If a company transacts business under a name other than registered with the Secretary of State, they are required to file a new fictitious business name statement. Further, if a company moves locations or gets new phone numbers, they are also supposed to file a new statement.

The job of recording such fictitious business names generally falls on the individual county clerk or recorders office in which the business is operating. Most often, fly-by-night operations will not take the time to file a DBA statement with their local county officials. Requiring a new customer to divulge any fictitious business names and registration numbers can go a long way in a vendor's self-preservation, by weeding out dead-beat customers who are not abiding by local laws.

Questions that should be asked on a credit application or supply contract can vary, but should include a request for information on any fictitious business names, the county recorded in, and registration numbers for those names. Generally, if a customer is able to provide these details with ease, the supplier will know that their potential customer is making their best efforts to comply with local laws and regulations, and most likely will do their best to pay their debts as they come due.

Fictitious Business Name Information

The purpose behind fictitious business name statements is to make available to the public identities of persons and companies doing business under a fictitious name. Seeking detailed information about a customer prior to entering into a credit agreement can, in the long run, save thousands of dollars of potential collection efforts and litigation costs. If a business has corresponded with a supplier under a different name than they have listed as registered with the secretary of state's office, it is essential that the supplier understand how their potential customer is registered, to avoid surprises later on.

In 2008, the Orange County, California County Clerk Recorder, Tom Daly, saw the

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LONGER ARMS FIND DEEPER POCKETS—THE DOCTRINE OF MARSHALING

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Intro

The priority of claims and the value attributable to competing claims are often the central concerns of any restructuring case.

Lien priority determines the order in which creditors are paid when the assets of a borrower are liquidated. Basically, a creditor's priority is determined by the *first to file rule* in the Uniform Commercial Code. Generally speaking, creditors holding a security interest in collateral are paid before unsecured claims and, as the rule suggests, holders of secured claims are paid in the order their claims were filed, starting with the earliest recorded lien.

The importance of having senior status is obvious. Senior claimants have the best chance of recovery, whereas junior claimants face greater risk that the senior priority claimants, either by nature of their number or the aggregate size of the senior claims, will deplete the pool of funds from which junior claimants can potentially recover.

Of course, the dynamic of relative priority status is never so simple. There are a host of topics that can arise to complicate the matter - subrogation, consolidation, contribution, just to name a few. The doctrine of marshaling is another such topic. Given its unique effect, however, it is well worth understanding and knowing when and where to utilize the equitable doctrine of marshaling.

Marshaling Defined

What is the doctrine of marshaling? It might be best to explain by way of example. Imagine the following scenario involving a corporate debtor with two pools of assets and two competing creditors.

To secure its debts, one creditor – say, a bank that provided the debtor financing -

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A VENDOR'S PRE-DEFAULTS RIGHTS IN THE FACE OF A RECESSION: CONVERTING A CREDIT SALE TO CASH

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The recessionary economy has resulted in a spike of corporate bankruptcies and out-of-court liquidations. The recessionary economy has also resulted in customers who have a long history of honoring their trade obligations now defaulting. Credit professionals are forced to reevaluate the credit risk with their accounts receivable portfolio, and reconsider their credit standards whether at the outset of the trade relationship, or with a longstanding customer.

In this economic uncertainty, the Credit Research Foundation surveyed members on whether the recession is affecting their credit and collection policies. This paper focuses on one aspect of the response to the survey, a vendor's pre-default rights to terminate the trade terms, and the legal requirements for the vendor to exercise this right, which may be an important right from time to time in this economy.

A More Common Situation in a Recession: Converting Credit Terms to Cash

Consider the following setting: the credit professional has evaluated the credit risk of a long standing customer of continued trade terms of 60 days. The vendor is a manufacturer with a lead time needed to manufacture the goods requested under the customer's PO. Prior to the release of the goods, but after the vendor has contracted with the customer to provide credit terms, the vendor is concerned with customer's financial condition. The vendor feels, especially given the recessionary economy and spike in bankruptcies and vendor defaults, that the customer will not be able to honor the trade terms because of financial conditions.

The vendor's preference is to hold the order and condition the release of the goods on a cash sale to avoid credit risk and a surprise bankruptcy filing. The customer's response, say a distributor, may be to threaten the vendor with a claim of breach of contract. The customer may contend that it has a contract with a retailer which requires delivery of the vendor's goods on a specific date and which may be tied to a promotion. If the vendor now conditions the sale on cash terms, the customer may not be able to purchase and, therefore, breach its contract with its customer, the retailer. The vendor's customer therefore views their loss of business with the retailer as damages you have cause them.

Documenting the Sale: What Your Contract Provides

For the vendor to have the greatest pre-default protection from a customer's claim of breach of contract, the vendor should consider terms contained in its credit application. The vendor's credit application may contain a provision that allows the vendor to revoke credit terms at any time, and is not conditioned on a customer's failure to pay invoices, or a specific instance that the vendor must point to indicating the customer's impending insolvency to justify pulling credit. Of course, in these recessionary times, the vendor will use this provision sparingly as the credit professional works with management and the sales force in continuing the trade relationship with the customer.

The Credit Research Foundation polled its members on credit strategies they are using in the recession. On the topic of managing pre-default credit risk, members considered the following:

1. Do you have a provision in your credit application, supply contract or invoice that provides you with the right to convert your credit contract to cash when you learn there may be problems with a customer's ability to pay on credit, but customer has not yet defaulted?

Yes	163	29%
No	406	71%
Total	569	100%

2. If YES, do you routinely exercise that right?

Yes	91	40%
No	139	60%
Total	230	100%

The responses indicate that a majority of the vendors selling goods on credit may have customers challenge their right to convert the credit sale to cash, as their credit application or supply contract is silent as to terminating credit extensions. Thus, vendors -should reconsider their credit application or supply contract to include the following provision, especially in a recessionary economy:

> [vendor] may terminate any credit availability within its sole discretion and has the right to terminate business relations with the undersigned.

Where Your Contract Is Silent: Demand For Assurance Of Payment

Where the vendor does not have a provision in its credit application or supply contract, then the vendor may look to state law to give some protection in converting credit to cash. Where a vendor has sold goods to the customer on credit and has grounds that the customer may not pay (termed "grounds for insecurity" under Article 2 of the UCC), the vendor may demand written assurance that the customer will perform. Where a supplier has agreed to sell goods to a customer on unsecured credit, the supplier may refuse to deliver and demand cash upon discovering that the customer is insolvent, as provided under Article 2 of the UCC. The UCC defines insolvent as either balance sheet insolvent (liabilities exceeds assets) or fails to meet debts when they become due.

An important distinction between the vendor having a provision in its credit application that allows for unilateral termination of the credit terms and a vendor looking to the UCC's demand for adequate assurance is justification. With the credit application, the vendor does not need financial justification to convert the credit sale to cash, although the vendor's management may be involved in the process, especially in a recession given the risk of losing sales. By contrast, the vendor that looks to the UCC for legal support to terminate the credit sale must have financial justification.

Note that in the construction industry it is common to have a contract that bars the general contractor from stop performance on a project for any reason.

Section 2-609 of the UCC provides:

a. A credit sale requires the buyer/ customer, and the seller/supplier, to perform. Should grounds for insecurity arise with a buyer's performance, the vendor may demand, in writing, assurance of performance. Until the vendor receives such assurance, the vendor may suspend performance.

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dentiality agreement to overcome the resistance. If the customer still refuses to share the information, this may be a red flag that the customer cannot honor a repayment agreement.

The vendor may also gather facts about the customer's financial standing, including assessing future sales as part of the repayment agreement, through third party comment, including salesperson visits to the account, contacting the customer's bank, which was given as part of the credit application process as part of the repayment agreement, talk to industry group members, other vendors and the landlord about their past experience with the customer. The Internet can also serve as a search tool to determine the availability and sufficiency of security should the vendor insist that the repayment agreement be secured, as well as an asset and UCC search, including real estate search.

The vendor should also confirm whether other creditors, including the debtor's landlord have initiated collection actions against the debtor. Many state and federal courts now have electronic dockets that the vendor can confirm whether lawsuits have been filed in the debtor's home venue. The importance of learning whether other creditors are being paid and, if not, what steps they are taking if not, is tied to whether the vendor has the luxury to work with the debtor to have the delinquent account paid over time. In some settings, certain creditors may be rushing to the court house to force payment on their delinquent accounts which forces the vendor to reassess the repayment agreement strategy.

With the framework of alternatives to a repayment agreement, the vendor must also consider the debtor's insolvency or bankruptcy risk. If the debtor files bankruptcy the automatic stay arises, which bars the vendor from collecting on the unsecured past due balance, including beginning or continuing lawsuits, collection calls, repossession, foreclosures, garnishments or levies. The automatic stay remains in effect until the bankruptcy judge lifts the stay at the request of a creditor, the debtor obtains a discharge, and/or the item of property no longer remains part of the debtor's bankruptcy estate.

The vendor must also consider the impact of a bankruptcy preference with strategies to collect on the delinquent account. A preference is a payment made by the debtor to a creditor within a defined period of time, prior to the debtor's bankruptcy filing. Because a preference gives the creditor who received the payment an advantage over other creditors in the bankruptcy case, the trustee can recover the preference (the amount of the payment) and distribute it among all of the creditors.

B. The Repayment Agreement in Action

Repayment agreements are a product of negotiation. The vendor seeks to include as many terms that create the leverage that the debtor will focus on honoring the repayment agreement. Some of the terms for the vendor to consider in a repayment agreement are:

Fixing the Indebtedness

In active trade relationship, where the vendor offers trade concessions to make sales and where the customer may take deductions, unauthorized and otherwise, the amount owing the vendor may be disputed. The debtor may also dispute the debt through claims such as defective product or late deliveries. Should the vendor sue to collect the delinquent account, the vendor may be surprised to find it the target of a counterclaim—a lawsuit filed by the customer. Given the uncertainty of the amount of the debt with some customers, a vendor may use the repayment agreement as a way to eliminate this kind of risk.

A repayment agreement should fix the amount owed, including fixing the amount of customer concessions and disputes. By fixing the amount owed, the vendor eliminates later disputes that may arise as to application of payments and concessions. Fixing the indebtedness can be helpful should the debtor fail to honor the terms of the repayment agreement and the vendor seeks to enforce the debt.

Fixing Repayment Schedule

The repayment agreement should provide a fixed schedule for repayment of the debt. The repayment schedule may be on a monthly basis. The benefit of a fixed schedule allows the vendor a clear timetable for repayment of the delinquent account rather than a mere understanding that the debtor will pay the amount owing when the debtor has free cash. This can be important where a debtor files bankruptcy and the vendor received payment within the 90 days prior to the bankruptcy filing

Discounting the Face Amount of Invoices

A repayment agreement requires the debtor's consent, and therefore may result in heated negotiations. Such issues as the term of the repayment agreement, the balance owing, additional credit sales, security, a guaranty, balanced with collection alternatives are considered by the vendor.

There may be instances where a vendor agrees to discount the face amount of the past due invoices to reach a compromise, say 10% or 15%. The repayment agreement may provide that in the event of a default by the debtor, the face value of the past due invoices become due and payable—the debtor loses the discount. An exception may be where the debtor defaults on the repayment agreement near its end. Should the vendor seek to enforce the face value of the invoices, a court may find such provision unenforceable.

Waiver of Counter Claims and Disputes

The repayment agreement protects the vendor from challenges later brought by the customer that an amount owing is in dispute, that the product or service provided is defective, or that the documentation supporting the debt is incorrect. By waiving all defenses, the debtor allows the vendor to promptly proceed to judgment should the debtor default on the repayment agreement.

Taking Collateral

Another method to have your customer focus on honoring the repayment agreement is to insist on collateral to back up the repayment agreement. This can take the form of the debtor granting a junior security interest in all of the its assets. Whether the debtor will grant such an interest will depend on the debtor's existing lender's consent, as well as the debtor's perception of other vendors' reaction to granting a security interest.

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Clean Up Documents

With the vendor's initial credit evaluation, there may be times where a customer refuses to sign a credit application, or in the rush for an initial sale a credit application is never taken. In these settings, the vendor may find its documentation is not in order. Perhaps a mislabeled invoices of who the customer is, or the kind of business organization the vendor has sold to. Should a dispute with the debtor arise, or invoices otherwise go unpaid, the vendor may find needless defenses raised by the debtor as to the documentation, which may slow payment on the account.

A repayment agreement may also help the vendor from the surprise of finding new owners of the debtor. Without the repayment agreement, the debtor's new owners may dispute their liability with the existing documentation. Depending on the duration of the repayment agreement, the vendor may include a notice requirement that the owners must notify the vendor in writing of any change in ownership, the name or the business structure under which the credit is established.

In addition, vendors that as part of the initial account evaluation that have taken collateral, such as a purchase money security interest or junior security interest in the debtor's assets, or have a consignment agreement, must comply with Article 9 of the Uniform Commercial Code. Should the vendor have failed to have properly complied, the vendor may find its security interest or consignment agreement subject to challenge. A repayment agreement can also be used to clean up what otherwise may be improperly perfected security interests or consignment agreements.

Guarantees

To back up the repayment agreement, the vendor may insist that the debtor's principal of a closely held corporation or limited liability corporation personally guarantee the past due debt as well as any future sales on credit. The personal guarantee is an inducement by the vendor not to take any creditor collection action, and, perhaps afford continued sales. If the debtor is part of a family of companies, the vendor may seek a cross corporate guarantee.

Preference Defense

Although the customer may enter into the repayment agreement and honor the payment terms of the repayment agreement with the vendor or class of vendors, the debtor may still be forced into bankruptcy. A vendor does not want to negotiate a repayment agreement and forebear on more immediate collection alternatives, only to find some or all of those payments clawed back by a trustee. A vendor that chooses the litigation alternative to collect on the past due invoices has a preference risk if the vendor levies on a debtor's accounts or records a lien against the debtor's property within 90 days of the preference filing. Thus, a question for the vendor is whether payments received under the repayment agreement during the 90 days prior to the bankruptcy filing a preference?

The vendor's defense to a preference demand is that the repayment agreement has replaced the delinquent invoices. Therefore, if the debtor paid according to the terms of the repayment agreement, the vendor may contend that such payment was made in the ordinary course of business under section 547(c) of the Bankruptcy Code and conformed with the repayment agreement, not past due invoices.

Favored Vendor Clause

If the vendor commits to take payment on the delinquent account over time, and perhaps discounts its invoices, the vendor does not want a surprise that the debtor has entered repayment agreements with other creditors with comparable balances o that treat the vendor less favorably. Therefore, the repayment agreement should provide that if the debtor favors a creditor that constitute a default.

Fees and Costs

The repayment agreement should include an attorney's fees provision, as well as late fees and default interest should the vendor be required to enforce the defaulted repayment agreement.

Venue

If the debtor is out-of-state, or out-of-country, the repayment agreement should provide that venue favors the vendor in the event of enforcing the defaulted repayment agreement.

Default

The vendor's patience of agreeing to take payment over time should not be rewarded with the debtor repeatedly paying late under the repayment schedule. To that end, to encourage the debtor to honor the repayment schedule, say payment is due the first of each month for the next six months, the debtor is faces a finance charge or late fee for the first late payment. However, if the debtor pays late a second time that may result in a default that is not curable and the vendor can obtain a judgment for the balance owing.

Acceleration Clause

Should the debtor fail to pay, the repayment agreement should provide that the entire balance owing under the repayment agreement is due.

Stipulated Judgment

A stipulated judgment is a judgment where the debtor and vendor have agreed to a judgment in the event of the debtor's default. If the repayment agreement is not followed, the vendor can file an affidavit of default where the judgment can be entered. Enforcement of the judgmet can take many forms, but can include property liens and levies.

Confession of Judgment

A confession of judgment provides that the debtor admits liability and agrees on the amount of debt that must be paid to the vendor. A confession of judgment may be filed as a court judgment against the debtor who does not honor the repayment agreement. The confession of judgment provision attempts to minimize the need to resort to legal proceedings to resolve the delinquent account. The enforcement of a confession of judgment depends on state law. Some states may not allow, while others give protections to the debtor by requiring that the must obtain consent from the debtor's counsel to be enforceable.

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Continued Credit Terms

In a recession, revenues continue to be essential for the vendor, especially as sales orders from financially sound customers are harder to come by. Likewise, for the debtor that is struggling to keep its supply sources providing terms, the debtor will often insist that the repayment agreement provide the vendor commit to terms for the duration of the repayment agreement. This is a call for credit, sales and management. Of course, the credit professional will need to provide a written opinion of the credit risk of future sales, compounded with the debtor repaying on the past due balance. This puts the credit professional in the role of customer relationship builder.

Credit Policy and SOX Compliance

In a recession, the best practices for a credit department is to document past due invoices that will be paid over time with a repayment agreement. Those vendors that are publicly traded and SOX compliant may have their auditors insist on repayment agreements as part of their internal controls and procedures. The repayment agreement may provide a more accurate recording of the collectability of the past due balance, and therefore financial reporting.

C. Repayment Agreement Alternatives

A repayment agreement requires the debtor's consent. If the debtor refuses to agree to a repayment agreement, the litigation alternative needs to be considered. A vendor may file suit for breach of contract, coupled with a prejudgment remedy such as a writ of attachment. This collection action my force the debtor into a repayment agreement in hopes of avoiding the suit. If the debtor does consent in this setting, the vendor should add the collection costs and interest to the past due balance.

If the vendor has an arbitration provision in its credit application or supply contract, the vendor may invoke this where the debtor refuses to the repayment agreement to deal with the past due invoices. As with collection suit alternative, the debtor may respond to the arbitration demand by consenting to the repayment agreement. The collection costs should be added to the past due balance.

D. Repayment Agreements in a Recession

Many long standing customers that have been a significant source of business for vendors may find themselves in financial difficulty as a result of the downturn in the economy. These are customers that have a good faith intention of working out their short term financial difficulties. In these settings, a vendor may be better served to work with the customer, but have a more formal commitment as to dealing with the dealing the delinquent account, such as a repayment agreement.

WRIT OF ATTACHMENT—ONE OF THE MOST POWERFUL TOOLS IN THE CREDITOR'S TOOLBOX

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States have very different standards for the issuance of a writ of attachment. Some states take a conservative approach and will only issue an attachment against a foreign debtor, or where the party is a victim of a crime, or where the debtor with intent to defraud his creditors or frustrate the enforcement of a judgment that might be rendered in the creditor's favor, has assigned, disposed of, encumbered or secreted property, or removed it from the state. However, other states, including California, allow the issuance of an attachment if the claim sued upon meets the following requirements:

- ◊ A "claim for money . . . based upon a contract, express or implied";
- ◊ Of a "fixed or readily ascertainable amount not less than $500";
- ◊ That is either unsecured or secured by personal property, not real property (including fixtures); a
- ◊ That is a commercial claim.

Because attachment lies only on contract claims, a creditor with alternative tort and contract claims based on the same set of facts (e.g., for the value of property obtained by fraud) "waives" the tort claim by obtaining a writ of attachment, so special consideration must be given if such claims exist.

Procedurally, the attachment is made through an application and hearing. Generally, attachments may be heard according to standard notice procedures. However, in California a creditor may move the court on an ex parte, or emergency basis, provided the creditor demonstrate "great or irreparable" injury to the creditor if the matter is heard on regular notice. This normally requires a showing that the property to be attached will disappear or be harmed pending a noticed hearing. Great and irreparable injury is deemed established, without further showing, in cases involving a bulk sales notice or liquor license escrow. Irreparable injury may also be inferred where the creditor files detailed affidavits showing the debtor is insolvent in the bankruptcy sense (failing to pay when due debts as they come and not subject to bona fide dispute). This is typically done by showing that the debtor has failed to pay other creditors or has ceased operating. At a minimum, many courts will grant an ex parte temporary protective order that prevents the debtor from transferring assets outside of the normal course of business pending a noticed hearing on the application for writ of attachment.

As for property to attach, all property within California held by a corporation, partnership or unincorporated association is subject to attachment if there is a statutory method of levy for the property. Practically speaking, the creditor will often look to levy on the debtor's bank account, accounts receivable or inventory. Property belonging to an individual, such as guarantor, is subject to attachment only if it falls within one of the categories such as real property, money, securities, etc. All other property belonging to an individual is exempt. Once attached, the property is taken into the possession of the sheriff or marshal.

As set forth, an attachment can be in essence a preview of things to come in the creditor's attempt to collect on that delinquent account – a method to shortcut through what can be a long and sometimes fruitless process in obtaining a judgment. While sometimes expensive and somewhat risky, the writ of attachment may be *the* way to create leverage and get yourself paid.

Guest Column

EFFECTIVE MEETINGS ARE NO ACCIDENT, INEFFECTIVE MEETINGS ARE A TRAIN WRECK

(Continued from page 2)

PHASE 1.
Before the Meeting: Pre-Meeting Planning

PHASE 2.
During the Meeting: Effective Facilitation

PHASE 3.
The Wrap Up: What was Decided, Follow-up Actions

PHASE 4.
After the Meeting: Documentation and Accountability

PHASE 1. Before the Meeting:

1) Determine the "Cost Benefit" for the meeting: MEETINGS COST MONEY! Remember you are "buying" each participant's time. If you are organizing a meeting or are being asked to attend a meeting of questionable value, ask yourself:

a. Is the meeting worth having? Is there an essential purpose? Will actions result? Does the stated meeting purpose have a direct affect on achieving company goals or targets? Is this just a pre-scheduled repetitive meeting that leads to nothing? Are the right people invited? Is there a clear agenda? In short: What is the compelling need for the meeting?

b. Will alternative forms of communication be just as effective? Will an email or brief conference call accomplish the same result as a face-to-face meeting?

2) Who should attend the meeting and why? If you are a Lead, Supervisor or Manager determine if it is more effective to delegate attendance to someone directly involved in the subject. Ask for a report of what happened. This approach has other advantages:

a. Attending valuable meetings can challenge and develops staff

b. Delegation of meeting attendance saves valuable management time

c. Puts "hands-on" people in the meeting

3) Some basics: If you are organizing a meeting be sure to do your homework in advance:

a. Reserve the room ASAP

i. Confirm the room the day of the meeting

ii. Will the room be unlocked?

iii. Know how to adjust room temperature and lights

b. Schedule the meeting with advance notice to participants and confirmation of who will attend. Include the proposed agenda with the meeting announcement. If this is a follow-up meeting detail follow-up actions from the previous meeting. (Old business) and what will be covered in this meeting. (New business)

c. Schedule the meetings at the most convenient time of day, week or month for participants (avoid 9:00 a.m., lunch hours, end of day, cut-off days, etc.)

d. Set up your meeting schedule so your commitments are not back-to-back. This avoids late arrivals and will allow you time to ensure the meeting room is available on time and materials are in place.

e. Determine who will facilitate the meeting in advance. The facilitator is responsible for:

i. Creating the agenda

ii. Keeping the meeting on track

iii. Ensuring everyone understands follow-up actions

iv. Document meeting minutes and follow-up actions

f. Prepare the room in advance of particpant's arrival:

i. Determine what equipment is needed in advance. Make sure the room and materials are ready and equipment is functioning before people arrive.
- Projector?
- A screen?
- Microphone needed? What type?
- A podium?
- An easel, pad, markers?
- Computer equipment?
- A white board with markers and eraser?
- Plan the room set up and table configuration that best suits the type of meeting: conference table? Class room seating? U shape table arrangement etc?

ii. Does the lighting work with the visuals? If you use a projector, does the light work? Does the PC function on the projector? (Turn on and focus in advance of the meeting.)

iii. If you are planning on incorporating video clips or sound is the equipment needed compatible?

iv. Long meetings require "creature comforts" Participants will have a more positive attitude if refreshments are provided at early morning or long meetings. Allow time for breaks if appropriate.

PHASE 2: During the Meeting:

The format and approach to the meeting is dependant on the nature of the meeting itself. There are several possibilities.

Informational ad hoc meetings: Avoid getting bogged down with detailed problem solving. Stay on point. Actions should be identified for follow-up and more extensive discussion.

Problem solving meetings: Meetings devoted to resolving a specific business issue should be well organized and focused. Use a methodical "brain storming" approach to discuss the issues at hand. The Facilitator is responsible to establish the following ground rules at the outset of the meeting:

1) No idea is a bad idea. Participants are not allowed to have "pride of authorship". During the course of the meeting disassociate ideas from the contributor. Encourage the group dynamic. Build off each participant's ideas to develop "group ideas".

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Guest Column

EFFECTIVE MEETINGS ARE NO ACCIDENT, INEFFECTIVE MEETINGS ARE A TRAIN WRECK

(Continued from page 8)

2) Honor schedules. Start and end the meeting on time. Shut the door at the assigned start time and begin. Chronic late arrivers will soon get the idea that the world in fact does not revolve around them. Although their input is valuable issues will be discussed and proposed actions will be communicated by the group after the meeting.

A few minutes prior to the scheduled end of the meeting the Facilitator should give the group a "time check". Provide time to summarize what was discussed and accomplished at the meeting. Verify everyone understands the action items and specifically what they are to do.

Only extend the meeting time if there is a unanimous consensus to do so. Your meetings will be more popular if participants know they can depend on the schedule.

3) Set the tone for the meeting and insist on participant's undivided attention:

a. Introduce participants

b. State meeting objectives and time schedule

c. Allow "No" interruptions from phone calls or "walk-in" questions. Cell phones and laptops should be OFF!

d. Allow only "One" conversation at a time

4) Keep the agenda on track: This can be a difficult challenge. Facilitators can use responses such as the following when someone interjects their own agenda or opens issues not specifically pertinent to the purpose of the meeting:

a. "Let's deal with that off-line."

b. "If we are going to keep on schedule, we have to move on."

c. "That's a good point. Let's focus on how it relates to our topic."

d. "There is so much to this, we need to set up a separate conference call or meeting to deal with it."

5) Seek out non participants: All communication in the meeting should remain non-threatening to the attendees. Avoid personal attacks or comments.

Ask an individual who is not participating for their opinion on the discussion thread in progress. Use open ended questions that can not be answered by a yes or no. (Examples: "John, how does this affect your area?", "Sally, you have experience with this. What do you think?" etc.)

Cross-Functional Communication/ Problem Solving Meetings: The best way to deal with complex business issues is to have every area affecting the problem meet together. This provides the cross-functional collaboration needed to resolve problems requiring buy in and cooperation from multiple departments. Cross-functional problem solving meetings can be scheduled regularly and become part of the continuous process improvement effort. Consider the following agenda guidelines:

1. Begin with old business: Review action items from the previous meeting. Each area should review their progress and discuss issues that are preventing completion of the follow-up action from the previous meeting.

2. New Developments: Each department has a scheduled time-frame to communicate new department initiatives or business changes that affects the other participants.

3. Help Needed: Each department discusses issues where the other departments are impacting them. The idea is to surface issues for collaboration and resolution, not to attack other departments.

4. Follow-up Actions: Identify specific actions to be completed prior to the next meeting.

PHASE 3. Wrap Up:

1) Summarize what was accomplished:

a. Review the agenda and restate what was accomplished

b. Assign actions and completion date

c. End on time

d. Be a good meeting citizen: Clean up the room so the next meeting can start with no delays

PHASE 4. After the Meeting:

1) Document the meeting discussion and action items. All participants and their manager should be copied. This informs stakeholders who did not attend and keeps them in the loop. It also adds additional accountability to those who have action items to follow through.

2) Invite feedback: Everyone will leave a meeting with a slightly different understanding and memory of events. Unfortunately that is just human nature. Successful Facilitators invite immediate comment on meeting notes and action items. This clarifies any misunderstanding early in the process. It also encourages buy in by participants. There are no surprises.

The Actual Cost of Meetings

Meetings have become so common in the workplace that there is seldom any question as to a meetings true value or cost. The cost of time spent, often wasted, is a valid consideration when deciding to have a meeting or not. Like every business decision thought should be made as to the meeting's "return on investment".

The following chart can help estimate the cost based on the average salary, number of participants and meeting time.

Proper management of the four meeting phases and consideration of a meeting's true "return on investment" will help reduce the number of meetings and wasted time. Effective meetings are action oriented and truly bring bottom line results.

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A VENDOR'S PRE-DEFAULTS RIGHTS IN THE FACE OF A RECESSION: CONVERTING A CREDIT SALE TO CASH

(Continued from page 4)

b. The customer's failure to provide assurance within a reasonable time, not exceeding 30 days, repudiates the contract and the vendor has no further obligation.

The two questions for the vendor with this remedy are whether the grounds for insecurity are reasonable, and whether the customer's assurance of performance is adequate.

On the first point, if the customer is publicly traded, access to the customer's financial information is easier to gather and, therefore, justification to hold the order is more easily supportable. The Sarbanes Oxley Act, Section 409, requires public companies to make prompt additional disclosures to the financial markets:

1. The removal or resignation of any corporate director and the entering into or withdrawing from an important agreement;
2. Agreements that are made or terminated outside the company's ordinary course of business;
3. Entry into a material agreement;
4. Termination of a material agreement;
5. Creation of a material, direct financial obligation or a material obligation under an off-balance sheet arrangement;
6. Events triggering a material, direct financial obligation or a material obligation under on off-balance sheet arrangement;
7. Material impairments;
8. Notice of de-listing from stock exchange or failure to satisfy listing standards and transfer of listings; and
9. If the company concludes, or the auditors inform the company, that previously issued financial statements, or a related audit report or completed interim review, should not be relied upon.

Given the more prompt and full disclosure that a public customer must make regarding its financial condition, the disclosure may result in you taking action earlier and perhaps holding orders more timely, thereby reducing the risk of loss. A Section 409 disclosure may trigger a process in which you determine whether or not open account terms are still appropriate, and if so, under what terms and conditions future sales can be made safely.

If the customer is privately held and therefore financial information is more difficult to obtain as the customer is not required to make financial disclosure, the vendor may need to look to industry group information, recent financial reporting from third parties, such as D&B, to indicate that the customer may be financial difficulty.

But what kind of information supports the vendor from converting the credit transaction to cash. If the vendor confirms that the customer's lender has called a default under the loan covenants, or a major vendor has terminated credit sales and is taking immediate action to collect on the past due balance, this can prompt the vendor to hold orders and demand adequate assurance. Likewise, if the customer refuses to respond to the vendor's demand to explain concerns about the ability to pay on terms in light of news about the customer's financial condition may be grounds to hold shipments and demand assurance of payment.

If the customer does respond to the demand for adequate assurance, what may qualify as financial assurance that the vendor should release the order according to terms previously agreed upon? A customer's mere representation that it can honor terms is not sufficient to compel the vendor to release the goods. However, if the customer provides the vendors with a detailed cash flow projections that support that the customer will have cash on hand at the time the invoice is due may be sufficient. Likewise, if the customer provide information from its lender that it is in compliance with its loan covenants may likewise be a form of adequate assurance. At a minimum, at this stage, the vendor should be able to receive financial information from the customer that otherwise was not willing to provide. The vendor may offer to take the financial information from the customer subject to a confidentiality agreement.

Reducing Credit Risk in a Recession

For the credit professional evaluating credit risk in a recession is complicated, especially if trying to determine whether the customer may no longer be able to honor its credit terms, yet has not breached the credit terms. Given the complications that may arise in demanding adequate assurance under the UCC and the risk that a customer may challenge that the vendor wrongfully terminated the contract, the vendor is better served by including a provision in its credit application that allows for the termination of the credit sale, pre-default, at its discretion.

If a customer refuses to sign a credit application or supply contract, the vendor is reminded that the UCC can provide protection where the vendor has identified credit default risk after the vendor has committed to terms, but not yet shipped.

EXHIBIT "A"

Transmit VIA Facsimile Tel. # nnn-nnn-nnnn AND overnight courier

Addressee
Re: *Demand for Adequate Assurance*
Dear [Addressee]:

[XXX] makes demand on [Debtor] to provide [XXX] with adequate assurance of performance of the credit sale.

On [date], [provide reasonable grounds for insecurity]. Accordingly, Debtor's statements show that Debtor is unable to pay as required.

Pursuant to Uniform Commercial Code §2-609, as adopted by [state] Uniform Commercial Code §2-609, a seller has the right adequate assurance of due performance from the buyer where reasonable grounds for insecurity arise. Additionally, after submitting a written request for adequate assurance, the seller may, if commercially reasonable, suspend any performance for which the agreed return has not been received. Furthermore, the buyer must provide adequate assurance of performance within a reasonable period of time.

Debtor's [action by debtor] creates the requisite insecurity that [XXX] may suspend performance. Additionally, Debtor's statements that it is unable to pay for services, and its current financial condition, lead to the conclusion that it is insolvent. Insolvency alone is sufficient to request cash payment for any future shipments of goods and performance.

Please provide [XXX] with adequate assurance that Debtor's future obligations will be performed no later than [date].

LONGER ARMS FIND DEEPER POCKETS—THE DOCTRINE OF MARSHALING

(Continued from page 3)

obtained a security interest over the debtor's assets and also obtained a personal guarantee from the principal or principals of the corporate debtor. The purpose of the guarantee, from the bank's perspective, is to create a second fund (after that of the corporate debtor's assets) to satisfy the obligation. The second fund is the asset pool consisting of the principals', potentially significant, personal wealth.

A second creditor, however – say, a vendor - was subsequently granted a security interest only over the debtor's assets.

Now assume that the debtor defaults on its obligations to both the bank and the vendor. Because the vendor's interest is junior to that of the bank's interest and because the vendor has no interest in the personal wealth of debtor's principals, what will happen to the vendor when the bank enforces its senior security interest in the debtor's assets? Will the vendor lose the value of its security interest in the debtor's assets should the debtor's assets fail to provide enough funds to satisfy both the bank and the vendor?

The answer, according to the doctrine of marshaling, is no. The doctrine of marshaling will allow the vendor to assert the bank's interest in the personal wealth of the debtor's principals secured by the bank's personal guarantee!

Marshaling Explained

While it may seem to do so, marshaling does not give the junior creditor any interest in the asset over which the rights are asserted. Instead, marshaling gives the junior creditor a right to resort to the senior security for its own debt. Of course, the junior creditor's rights are not limitless; a junior creditor may only marshal the lesser of the amount the senior security interest secured and the amount left owing to the junior creditor.

The doctrine of marshaling rests on the equitable principle that a creditor having two funds to satisfy his debt, by applying a shared fund to his own debt and thereby depleting it, may not defeat another creditor who has only the one shared fund with which to satisfy its debt. Marshaling is meant to protect the junior creditor from the effect of choices of enforcement strategy by the senior creditor. It is meant to do so without interfering with the senior creditor's enforcement decisions and without granting the junior creditor more than it could reasonably have expected to result from its security had the senior creditor realized on the asset over which it alone had security. These are the factors that limit the amount a junior interest can recover through the doctrine of marshaling.

To explain, take the limitation that a junior creditor may only marshal up to the amount the senior security interest secured and return to the hypothetical set out above. Had the bank enforced its interest via the personal guarantee first, i.e. on the assets of the debtor's principals, the vendor would be able to enforce his interest against the debtor's assets to the full extent of the shared collateral's value. Hence, where the bank enforces its interest on the shared collateral first, leaving nothing for the vendor, the vendor may only marshal the amount the bank's security interest (in the debtor's assets) secured. In other words, the junior creditor may only marshal to the full extent of the shared collateral's value. After all, this is all the vendor would have realized had it acted alone, upon its own security interest in the debtor's assets, without the interference of the bank.

The other limitation, that a junior creditor may only marshal up to the amount left owing to it by the senior creditor, is easier to explain. Where our hypothetical bank enforces its interest on the debtor's assets leaving a residue, the residue would go to the vendor and the vendor could collect the remainder of its claim, if any, through the bank's personal guarantee. Thus, where the senior creditor enforces its interest on the shared collateral leaving a residue, the junior creditor may only marshal to the extent that it was left impaired.

In short, marshaling, when applied, requires a senior creditor to satisfy its claim first from the property or fund in which a junior creditor has no interest.

The Application of Marshaling

A party seeking the application for marshaling must generally establish the following elements

1. The existence of two secured creditors
2. A common debtor (or alter-ego)
3. the existence of two funds belonging to the debtor
4. The right of the senior creditor to satisfy its demand from both funds
5. The right of the junior creditor to resort to only one
6. The marshaling of assets for the benefit of a party must not result in prejudice to other interests of another party

The Value of Marshaling

There is no doubt that the ability of a junior ranked creditor to assert the doctrine of marshaling is valuable. It has important implications for creditor recoveries vis-à-vis other secured creditors as well as unsecured creditors and represents a second pocket to payment for vendors who have not taken credit enhancements.

In fact, even where a customer has filed chapter 7 bankruptcy, there is an opportunity to receive payment on an unsecured clam even though a secured creditor asserts a security interest in all of the debtor's assets. A majority of courts have held that the chapter 7 bankruptcy trustee, as a hypothetical lien creditor under §544 (a), has standing to seek marshaling for the benefit of the estate. Accordingly, a distribution for the debtor's unsecured creditors may be preserved. Take note, however, that unsecured creditors do not have standing to assert marshaling on their own, nor do chapter 11 debtors.

More commonly, though, it is a junior creditor that moves to compel a senior creditor to marshal assets. By acting collectively, junior creditors will likely benefit by having more influence over the senior interest than if they act individually. Junior creditors must also act early. If a junior creditor knows that a senior creditor contemplates selling secured property of the debtor, but does nothing to prevent the sale, the junior creditors may not assert marshaling.

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DOING BUSINESS AS: INFORMATION PROTECTS YOUR COMPANY DURING A RECESSION

(Continued from page 3)

lowest amount of DBAs in at least four years. This can be seen as a measure of the economic troubles, and also can been seen as many businesses simply forgetting or delaying their compliance with regulations.

Despite regulations requiring fictitious business name statements, the county recorder offices do not have the power to enforce penalties on businesses that do not comply with local DBA rules. The recorder can only refer certain cases to the district attorneys office. The California penalty for knowingly filing an incorrect fictitious business statement is a misdemeanor and may carry with it a fine not to exceed $1,000.

Because the recorder's office does not have an enforcement arm to ensure compliance, and the penalties for not complying are relatively insignificant, it is of the upmost importance that vendors and suppliers use these fictitious name regulations to their benefit, as a tool to investigate with whom they are transacting business.

All business registration information can be obtained on-line. Because of the advances at the Secretary of State and County Recorder's offices, a company can easily follow up on information provided by a customer. Taking a few minutes after receiving a customer's information to verify the truthfulness of the answers could save hundreds or thousands of dollars in collection costs.

Revisiting Your Current Documents

In a time where many businesses are feeling the economic squeeze, a vendor should be all the more vigilant in requiring complete and comprehensive disclosure of information for new customers. Taking the time to have your credit application redrafted by counsel can be a key in preventing fraud and can strengthening business relations. If suppliers and vendors insist on disclosure of the fictitious business name filing information in order to transact business, the amount of businesses which are registered and will comply with regulations will surely increase. By revising current documents to require potential customers to divulge all information about their business and any other names they operate under allows the vendor to better understand with whom they are dealing, and will allow the vendor to recognize potentially fraudulent customers, saving future costs of collection and litigation.

USE STRONG ARM POWERS AND LIEN AVOIDANCE AS A METHOD OF OBTAINING ASSETS

(Continued from page 2)

lien by a County Taxing Authority, *El Paso City of Texas v. America West Airlines, Inc.*, 217 F.3d 1161 (2000), the County Taxing Authority sought to assert its secured lien in the debtor's bankruptcy case for taxes owed on personal property. Texas state law requires the County Taxing Authority to file a notice of a secured lien with the county recorder's office in the county where personal property is located to perfect a tax lien on personal property. The County Taxing Authority did not file the required notice of lien until after the bankruptcy case was filed. The court held that the County Taxing Authority's secured lien was avoidable, and therefore, the claim was disallowed in its entirety. A question that has yet to be answered in a published case is whether the taxing Authority should still be allowed a priority tax claim, or whether the claim is lost in full.

These cases are a sobering reminder to secured creditors to ensure that all state laws are properly followed when recording security interests, and that liens are timely filed, but it is an even better guide for trade vendors in evaluating their prospects for payment in the bankruptcy setting. Specifically, trade vendors should ensure that the trustee, the debtor-in-possession or the creditor's committee is properly evaluating all liens under the applicable state's laws on the debtor's property before there is any conceding as to that lien status. Secured lenders, and even governmental taxing authorities, make mistakes in perfecting their security interests.

LONGER ARMS FIND DEEPER POCKETS—THE DOCTRINE OF MARSHALING

(Continued from page 11)

Conclusion

Therefore, while it may not be the most commonly applied doctrine, it's important keep an eye out for the situations in which marshaling applies. Likewise, scrutinizing intercreditor, lien subordination, or other agreements which might include provisions asking junior secured creditors to waive their rights under applicable law to assert the doctrine of marshaling is well worth the effort. Otherwise, pools of assets which appear out of reach – will stay out of reach. Instead, allow the doctrine of marshaling to give you longer arms with which to reach asset pools to which you couldn't previously. You will quickly see how longer arms makes deeper pockets a little easier to find.

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