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THE TRADE VENDOR QUARTERLY

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

CONSIGNMENT CREDITORS BEWARE: COMPLY WITH THE UCC OR RISK LOSING YOUR GOODS

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Of a credit executive's many responsibilities, one of the most important is managing credit risk. One alternative to a sale on open account is a sale on consignment. Consignment sales minimize the risk of non-payment, and can be a desirable way of doing business with a retailer or wholesaler on shaky ground. Of course, a consignment transaction is not a true sale until the customer (consignee) actually sells the goods; until then, title remains with the owner, usually the manufacturer (consignor).

For the manufacturer or owner who puts up merchandise for sale, the process of selling inventory on consignment does introduce risk wherever there is the possibility of a competing creditor's claim. Inventory, or proceeds from the sale of that inventory, may become prey to other creditors unless the consignee has complied with the Uniform Commercial Code's (UCC) requirements for perfecting a security interest in the inventory. As the case of *Bank of California v. Thornton-Blue Pacific*[2] illustrates below, where a consignor fails to take these steps to protect ownership of its inventory, the consignor risks losing the inventory the inventory, or the proceeds from the sale of the inventory, to a competing creditor.

Consignment Sales

The technical definition of a consignment sale is one in which a consignee has taken possession of merchandise from the goods' owner. The owner is the consignor. The consignee has the obligation to pay the consignor from the proceeds of the sale of the merchandise. The consignee receives a commission or some other recompense for making the sale. If the consignee does not sell the goods after all, he may return them to the consignor without obligation. Title to goods on consignment remains with the consignor until the sale takes place.

Complying With The UCC

Article 9 of the UCC's perfection requirements provides the means whereby a consignor can establish a valid security interest in his own inventory, even when that inventory has been delivered to a consignee. Compliance with the perfection requirements not only protects ownership of inventory; in the event of a dispute over the goods, the consignor will prevail over a competing creditor.

Perfecting a security interest is a multistep process that begins with the consignor. An agreement is executed describing the relationship of the parties involved (i.e., the owner is consignor and the seller is consignee); a description of the inventory; and agreement that title to the merchandise only passes to third-party buyers. Then the consignor completes a UCC-1 financing statement which again describes the inventory and makes clear that the inventory is delivered on consignment. The consignor then files the statement with filing office (usually the Secretary of State).

The consignor seeking to establish a security interest in its inventory must take additional steps if the consignee has a preexisting, inventory-secured creditor. For the consignor's security interest in its inventory to prime the lien of a pre-existing creditor, the consignor should first make sure that its UCC-1 and consignment agreement has already been recorded at the time the consignee receives possession of the inventory.

Secondly, the consignor must give written notice to any pre-existing, inventory-secured creditor. It is the consignor's responsibility to check the filing office to determine that the consignee-debtor and its secured creditor have filed financing statements covering inventory and after-acquired property The consignor's written notice to the inventory-secured creditor should state that the consignor is delivering inventory on consignment to the consignor-debtor.

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CASHING CHECK MAY NOT BE ACCORD AND SATISFACTION

Scott Blakeley

Consider the following common situation. A debtor disputes the amount of its delinquent account. The debtor contends that $100,000 is owed, while you claim $125,000 is due. The debtor mails a check for $110,000 in an attempt to resolve the dispute. The debtor writes on the check “payment in full.” What are the consequences if you cash the check? By cashing the check, do you waive the right to the balance you believe you are owed?

A recent opinion from the Court of Appeals for the Seventh Circuit[1], discusses the legal principle of “accord and satisfaction”; how a debtor and creditor may rewrite a contract to settle an account dispute without court intervention. The opinion reminds parties that an accord and satisfaction may be effected only where there is an honest dispute between the parties as to the amount due at the time payment was tendered. The debtor must make clear that issuing the check is intended to settle the outstanding claim between the parties and that the creditor, by cashing the check, accepts the settlement.

Accord And Satisfaction

Accord and satisfaction is generally defined as a substitute contract between a debtor and creditor for the settlement of a debt for a different amount than allegedly owed. Accord and satisfaction has evolved from common law principles that encourage parties to settle a disputed debt without judicial intervention.

Under the common law, if a creditor receives a check for less than the full amount owed and that check contained a conspicuous notation that it was tendered as satisfaction of the entire debt, the creditor had two options: (1) reject the offer by returning or destroying the check; or (2) cash the check and accept the accord. A creditor can not avoid an accord and satisfaction by either reserving his or her rights by writing on the check or by crossing out the full settlement language on the check.

FROM THE PUBLISHER:

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If you have a hot topic affecting the credit and financial professional, e-mail this to Scott.

The Uniform Commercial Code (UCC) codified the common law, with some variations to reflect modern business practices. Section 3-311 of the UCC specifically deals with accord and satisfaction in the commercial marketplace. Certain states, such as California, have overlapping accord and satisfaction provisions in their UCC and state statutes.

The “accord” is the agreement between parties to accept something different from, or less than, the amount one party contends is owed. The “satisfaction” is the execution of the agreement, which extinguishes the obligation.

Under the UCC, before an accord and satisfaction can be established, there must be a bona fide dispute between the parties. To determine whether a bona fide dispute exists, the test is whether the dispute was in good faith. Ordinarily, a party must ordinarily prove that they acted in good faith in tendering an instrument as full satisfaction of a claim. Thus, there must be an honest dispute between the parties as to the amount due at the time payment was tendered. When a party is acting dishonestly as to the dispute, they will not meet the good faith test.

Before a check can create an accord and satisfaction, the party who presents the check must make clear -- by appropriate and conspicuous wording -- that cashing the check will be construed as settlement of all outstanding claims between the parties. Such notation can take the form of a debtor writing on the check, or accompanying voucher: “Payment in full settlement of the stated accounts” or “Endorsement of the check constitutes a complete settlement of your claim” in conspicuous letters.

Under the UCC, a party may avoid an accord and satisfaction by returning the money within ninety days. A party’s bid to prevent a satisfaction by accepting the check but scratching out the restrictive endorsement and adding the words “without prejudice” is of no avail. Under the UCC, words of protest cannot change the legal effect of an accord and satisfaction once a check has been cashed.

The UCC provides for prevention of an accord and satisfaction mistakenly taking place. Sometimes checks are sent to an automated collection center of a large organization and are cashed without inspection. A creditor may require that, to be effective, any attempted accord and satisfaction must be sent to a particular office.

Accord And Satisfaction In Action

The court in *McMahon Food Corp. v. Burger Dairy Co.* considered accord and satisfaction. A vendor regularly sold milk products to the debtor, a distributor of dairy products. The vendor invoiced the debtor weekly. A dispute arose between the parties as to unauthorized deductions taken by the debtor for product shipped, as well as unauthorized credits taken by the debtor for empty milk cases returned. The parties met to resolve the dispute. They examined the invoices and payment practices. No agreement was reached as to the delinquent account; according to the vendor who continued to bill the debtor the amount it claimed was in arrears. The debtor alleged that the vendor agreed to take less than the amount

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Industry Focus: Commercial Printers

PRINTER CANNOT COLLECT AS JOINT VENTURER

Scott Blakeley

A credit executive in the commercial printing industry has a unique set of concerns. Commercial printers often are required to publish large production runs under the terms of a printing contract. These large runs can quickly create a large account- receivable for the printer. Too often, commercial printers find that the contracting party is unable to pay for the goods after the printing is complete. In such a case, the printer may have a contract under the terms of which it can retain the printed materials as collateral. That is not the best recourse, however, when the printed materials have little value to the printer (other than for, perhaps, attempting to leverage payment on the account).

When the contracting party does not pay up, is there another pocket for the commercial printer to collect from? Are there claims that the commercial printer may hold against another party that benefits from the printed product?

In *Ringer America, Inc. v. Land O'Lakes, Inc.*,[1] the Court of Appeals for the Eighth Circuit recently considered whether a commercial printer could hold a third party responsible for an unpaid debt. The printer's customer was a publisher. The printer contended that the publisher and the publisher's customer had formed a joint venture to publish a magazine, and so the publisher's customer shared liability for the debt. The joint venture theory is considered below.

Agreement To Print Between Printer and Publisher

A commercial printer (Printer) agreed to print magazine-style cookbooks under a printing services contract with a publisher (Publisher). The cookbooks were to be printed for the benefit of the Publisher's customer (Customer). The Customer manufactured and distributed dairy products. The cookbooks, which promoted the dairy products, were to be distributed to consumers, as part of the Customer's marketing strategy. The Customer was not a party to the printing agreement between the Printer and the Publisher.

Agreement to Publish Between Publisher and Customer

The Publisher and the Customer also entered into a specific payment agreement. Under this agreement, the Publisher and the Customer undertook to publish and market a magazine-cookbook using the Customer's trademarks and trade names. The Customer determined the release of each cookbook and retained final rights over the finished product. The Publisher provided editing, layout, illustrations, printing, binding, packaging and shipping services.

The payment agreement between the Customer and the Publisher was as follows. The Publisher agreed to reduce the charge for its services by 20% in exchange for 20% of the profits from the cookbooks. The agreement between the Publisher and the Customer stated:

> "This Agreement is not intended and shall not be construed to constitute either party as the employee, joint venture or franchising partner, agent or legal representative of the other. Neither party shall have any authority, express or implied or apparent, to assume or create any obligations on behalf of or in the name of the other party."[2]

What Is A Joint Venture?

A joint venture is an undertaking by two or more entities, with or without a corporate or partnership designation, formed for carrying out a particular transaction. The parties agree to share losses and profits. The parties combine their property, money, efforts, skills, or knowledge in a common undertaking. The parties must also jointly participate in the management and control of the business.

After the cookbooks were distributed, the Publisher began using its revenues from cookbook sales to pay the Printer's invoices. These revenues were earmarked for payment to the Customer.

The cookbooks were not a success, and the Publisher had cash flow problems. The Publisher was delinquent in remitting revenues to the Customer. The Customer demanded a change in its contract with the Publisher. The Customer demanded that the "float" provision for revenues from the cookbooks, the source of payment for the Printer, be eliminated and that the Customer be paid immediately from those revenues.

After this change, the Publisher failed to pay the Printer. The Printer refused to print. The Customer paid the Printer for a final print run, and retained another Printer to finish the project.

The Printer sued the Customer for unpaid printing services asserting a joint venture between the Customer and the Publisher, which obligated the Customer to pay for the unpaid printing services. The Printer did not sue the Publisher apparently because the publisher could not satisfy a judgment. The trial court denied the Printer's joint venture claim because the essential element of a joint venture claim, joint control, was missing. The Printer's claims for unjust enrichment and quantum meruit were denied as the parties' rights were governed by contract. The Printer appealed.

Obligations For Debt Flow Solely To Contracting Party

The court rejected the Printer's contention that a joint venture existed between the Publisher and the Customer because the Customer never contracted with the Printer for printing services.

> "Where one, with knowledge of a partnership elects to contract with an individual member of the partnership upon that member's exclusive credit, even though the contract is for the benefit of the partnership, the member contracted with and he alone is liable under the contract."[3]

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SECTION 547(C)(4): MUST THE NEW VALUE REMAIN UNPAID?

Scott E. Blakeley[1]

Editor's note: the following article will appear in two parts in this and the next issue of the Trade Creditor Quarterly.

I. INTRODUCTION

The Bankruptcy Code vests the trustee with far-reaching powers to avoid transfers and transactions prior to a bankruptcy filing. The power to avoid preferential transfers is one of the trustee's most potent weapons. Bankruptcy Code § 547(b), along with judicial interpretation, defines a preferential transfer expansively to include nearly every transfer by an insolvent debtor during the preference period.

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

Not all transfers made within the preference period are avoidable. In § 547(c), Congress has carved out seven exceptions to the trustee's recovery where the transactions replace value to the estate previously transferred. A majority of courts hold that § 547(c)(4) embodies a subsequent advance rule (hereinafter, the "subsequent advance rule"). Under this exception, Congress excepts from avoidance those transfers to a creditor who subsequently extends goods or services (or credit for those goods or services) (hereinafter the "subsequent advance") to the debtor. The subsequent advance rule has its most frequent application with the pattern where a creditor provides goods or services on open account and the debtor repays at various points during the preference period.

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

The five circuits which have ruled on the issue are split four to three: the Third, Seventh, Eighth, and Eleventh Circuits enunciate a rule that the subsequent advance must remain unpaid. A majority of courts have adopted this position (hereinafter the "majority rule").

The Fourth, Fifth and, most recently, the Ninth Circuits reject the majority rule and hold that the subsequent advance need not remain unpaid, to satisfy § 547(c)(4). Rather, these courts hold § 547(c)(4)(B) requires only that the debtor not make an "otherwise unavoidable transfer" on account of that advance. As the Ninth Circuit recently stated in *IRFM*: "Instead of barring the new value defense altogether anytime new value has been repaid, this approach allows the new value defense if the trustee can recover the repayment by some other means."[2] The trend of most trial courts recently is to adopt this view (hereinafter the "emerging viewpoint").

This article examines the mechanical operation of the subsequent advance rule, the current status of the case law, including analysis of the competing positions of the courts, and the policy objectives supporting this exception. The article will then argue that the plain language of § 547(c)(4), as well as policy objectives supporting the exception, are better served where the subsequent advance paid by the debtor is not subject to avoidance, provided such payment is an "otherwise avoidable transfer."

II. THE STATUTORY SCHEME

A. THE SUBSEQUENT ADVANCE RULE

The subsequent advance rule prohibits recovery of an otherwise voidable transfer if (1) the creditor extended subsequent, unsecured, new value to or for the benefit of the debtor, and (2) the extension induced an "otherwise unavoidable transfer" from the debtor to the creditor. A creditor has the burden of establishing these elements.

While § 547(c)(4) does not expressly require that the subsequent advance match the preference, the *PNP Holdings* bankruptcy court recently added the gloss that the advance must relate to the preference. The subsequent advance rule is Congress' answer to protect the running account creditor. Under this analysis, a single transfer is not analyzed in isolation from the overall course of business between the creditor and debtor, as the basis for maintaining the open account is the debtor's entire financial picture and not the debtor's most recent payment.

The following policy objectives support the subsequent advance rule: (1) to encourage creditors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy; (2) to promote equality among creditors; and (3) to reward creditors who actually enhance the estate during the preference period. As the Eleventh Circuit stated:

> "A subsequent advance is excepted because it is reasoned that a creditor who contributes new value in return for payments from the incipient bankrupt, should not later be deemed to have depleted the bankruptcy estate to the disadvantage of other creditors."[3]

Without the exception, a creditor who continues to extend credit to the debtor would merely be increasing its bankruptcy loss and in effect be punished for continuing to work with the debtor.

B. THE BANKRUPTCY ACT AND ELIMINATION OF THE NET RESULT RULE

The subsequent advance rule derives from § 60c of the Bankruptcy Act of 1898. That section provided that where a preferred creditor, in good faith, gives further

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SUBORDINATING A SELLING SHAREHOLDER'S CLAIM

Scott E. Blakeley

It is common for closely-held corporations (corporations whose shares are held by a single shareholder of a small group of shareholders) to repurchase their own stock upon the death or retirement of one of the shareholders. Frequently, stock buy-outs such as these are structured so that the corporation delivers a promissory note to the selling shareholder to provide for payment for the purchase of the stock. These stock buy-outs are often financed by the corporation-as-debtor, borrowing from a lender. The shareholder, or his or her estate, may find appealing tax aspects in a stock buy-out that features payment over time, such as quarterly payments, as opposed to an immediate cash-out.

What about vendors? Ordinarily, a stock buy-out is a non-event to vendors who have sold to the corporation on open account. It may even provide additional open account sale. More often, vendors make a modest adjustment to the line of credit they offer their corporate customer to account for the change in a corporation's capital structure and addition to its long term debt.

On occasion, however, a stock buy-out may lead to a debtor's financial distress, and even carry it into bankruptcy. Leveraging its assets to finance a buy-out may leave a debtor with unreasonably small capital to operate its business. The debtor may then incur obligations that it cannot repay, such as borrowing from its vendors in order to continue operations, as well as to service new obligations to the lender and to the selling shareholder.

In a bankruptcy case from Massachusetts, a selling shareholder asserted a claim against the bankruptcy estate based on the balance due from the debtor on a promissory note. The bankruptcy court, in keeping with the policy of fair distribution, ruled that this claim could be subordinated, and that the selling shareholder should share the bankruptcy assets equitably with the unsecured creditors. The court ruled that the claim could be subordinated notwithstanding the fact that the stock buy-out was entered into several years prior to the bankruptcy filing, and that the debtor was solvent at the time of that transaction.

The court's ruling may provide a weapon for vendors, whose claims would otherwise be in parity with a selling shareholder's claim. The ruling sends a message to principals that their stock buy-out agreements may be subject to attack even if the corporation was supposedly solvent at the time of buy-out, and even if the buy-out was entered into years before a bankruptcy. The doctrine of equitable subordination, which is a remedy available to unsecured creditors exclusively under the Bankruptcy Code, has significance, because generally, state law will only invalidate such buy-outs when the debtor was insolvent at the time of the buy-out, or where the buy-out impaired the corporate debtor's capital.

Sale of Shares and Promissory Note

In the Massachusetts case, the debtor, a closely held corporation entered into a agreement with a trust controlled by the debtor's shareholders, officers and directors. The debtor agreed to purchase the shareholder's stock for approximately $650,000, and issued an unsecured promissory note with a term of 15 years, payable in equal monthly installments, bearing interest at the rate of 12 percent. The debtor's certified financial statements reflected a net worth of approximately $3 million, a net profit of $433,000, and current assets in excess of current liabilities at $3,150,000 shortly after the stock repurchase.

Several years later, the debtor filed Chapter 11, which was later converted to Chapter 7. The selling shareholder filed an unsecured claim for $542,246, which represented the balance due on the promissory note. The Chapter 7 estate had assets to pay a percentage of trade creditors' claims. The creditors' committee objected to the selling shareholder's claim, and requested the claim be equitably subordinated to competing trade creditors' claims.

Subordinating The Selling Shareholder's Claim

Equitable subordination is a doctrine unique to bankruptcy law. The Bankruptcy Code expressly recognizes the creditors' right to equitably subordinate certain claims. A majority of courts interpreting the subordination provision of the Bankruptcy Code adopt a three-part test: (1) if the claimant has engaged in inequitable conduct; and (2) the misconduct results in injury to competing claimants; and (3) the subordination is not inconsistent with bankruptcy law; then the claim in question may be subordinated.

Here, however, the creditors' committee did not contend that the selling shareholder acted inequitably. The creditors' committee's objection was instead based on the origin of the claim: the repurchase of stock, which was, in effect, a claim to a shareholder distribution. The court looked at the substance of the transaction and noted: "[a] corporation's redemption of its own stock is in essence a dividend for which the corporation receives no consideration."

The court looked to the principles of equitable subordination and found that, as unsecured creditors are the presumptive owners of an insolvent corporation, unsecured creditors are entitled to payment prior to shareholders. A selling shareholder's claim is equivalent to a stock dividend claim, the court reasoned, and equitable subordination was in this case appropriate.

What about the stock buy-out agreement? The court surveyed state law to determine whether it was valid. For instance, under California and Delaware corporate law a corporation is only prohibited from purchasing its own shares when the purchase would make it insolvent or if the purchase impairs the capital of the corporation. Under the Model Business Corporation Act (under which most states have modeled their corporate statutory schemes) redemption is prohibited only when the corporation is rendered insolvent.

Here, the stock buy-out agreement did not immediately render the debtor insolvent nor did the repurchase immediately impair the capital of the corporation. So, under state law, the buy-out was permis-

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BUST-OUTS ON THE RISE: WHAT YOU CAN DO TO PROTECT YOUR CREDIT SALES

Scott Blakeley

The Wall Street Journal (WSJ) featured an article, "Bust-Out Swindlers Appear to be Busting Out All Over". The article stated that bust-out schemes have risen 30-50 percent in the last five years, reaching all time highs recently. The WSJ article also discussed how bust-outs are directed at all sizes of companies and cut across all industries. The message? No vendor is immune from a bust-out.

The Bust Out In Action

A bust-out is a scheme devised to defraud vendors of their merchandise through the use of planned bankruptcies and business failures. Bust-out schemes are usually orchestrated in two stages. The first stage may be characterized as laying the groundwork for the bust-out and the second stage as execution.

In the first stage, the usual practice of bust-out operators is to create a fake corporation (a fast, inexpensive task), establish a credit account with one or more vendors, make small purchase orders, and pay within invoice terms on the limited credit provided. In this way, the bust-out operator establishes good credit (i.e., credibility) with vendors. Bust-out operators have found that having a Fortune 500 company as a reference can go a long way towards avoiding thorough credit checks.

Vendors become unwitting participants to a bust-out when they do not conduct thorough credit checks of new customers. A vendor's resources to do so often limited, while increasing competition in many fields has pushed large numbers of vendors to relax their credit standards. Unsuspecting companies of any size, including Fortune 500 companies, are vulnerable to bust-out schemes.

Some large companies have sophisticated credit departments, yet even some of these become lax when an order involves five-digit or six-digit amounts. The bust-out operator takes possession of the merchandise, then sells it at a steep discount -- often to legitimate businesses. The cash from the sale is used to pay for prior orders, until it is time to execute the bust-out.

In the second stage of the bust-out, the execution, the operator places large orders on open account with as many vendors as possible. He or she then sells the merchandise at big discounts in return for immediate cash payment, and files for bankruptcy liquidation or merely disappears. Far from being experienced businessmen who have stepped over the line in their business decisions, but-out operators are usually members of criminal rings that operate for the sole purpose of defrauding vendors.

A Vendor's Due Diligence

Due diligence is crucial for credit executives wishing to avoid a bust-out. There are red flags in a bust-out that credit executives should attempt to identify in the course of their transactions. This can limit the risk of selling into a bust-out. Common red flags include a fake company name that is similar to the name of a well-established company. Another flag is unusually large profits depicted on the income statement -- if that statement is even provided. Indeed, it may be delivered to an address other than the business address. Finally, a large merchandise order following a history of small orders should raise a question for a credit executive dealing with a relatively new vendor.

There are several steps credit executives can take to protect themselves. These steps include: keep the vendor's credit functions and sales functions separate; visit the new customer during business hours and observe sales behavior; visit the customer when the business is closed; ask for a personal guarantee; and discuss the account with other vendors in the industry group.

Legal Rights

Because successful, cost-effective le-

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MAKE CLEAR WHO IS GUARANTYING YOUR DEBT

Scott Blakeley

The concept of an unsecured personal guaranty with the commercial sale of goods on credit is seemingly straightforward. A party, usually a principal of the company purchasing the goods (the guarantor), states to the vendor that if the vendor will sell to the debtor on credit, the guarantor will guarantee the payment. This promise to pay by the guarantor is an inducement for the vendor to sell the debtor on open account. The guaranty creates a contract of secondary liability.

A personal guaranty often is perceived by the credit professional to have questionable collectability. However, the personal guaranty may assure payment on the open account where a debtor is in financial straits and is unable to pay all vendors. The guarantor will likely direct those debts that are not personally guarantied to remain unpaid, to avoid personal lawsuits for collection of the personally-guaranteed debt.

A credit executive must take certain steps to ensure he or she has a valid guaranty to avoid unnecessary legal attacks by the guarantor. A recent case from the Court of Appeals for the state of Washington[1] illustrates where a form guaranty was sufficiently ambiguous to open the door for the guarantor to challenge whether the creditor held a valid guaranty.

A Guaranty From The President?

In *Wilson Court*, an individual who was the president of a company that operated fast food restaurants, guaranteed of the company's long-term agreement with a creditor. The individual signed the guaranty and added the title "President" after his signature. The guaranty did not indicate whether the signer was obligating himself or the company he represented, referring to the guarantor only as the "undersigned":

> "The undersigned hereby guarantees to [the creditor] . . . the

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BUST-OUTS ON THE RISE: WHAT YOU CAN DO TO PROTECT YOUR CREDIT SALES (Continued)

(continued from page 6)

gal remedies for a bust-out are limited, due diligence is critical for a vendor. After a vendor has sold into a bust-out, it is extremely difficult to recover goods or to satisfy a monetary judgment against the bust-out operator.

When the business failure does not involve a bankruptcy filing, a vendor's prejudgment remedies, such as a writ of attachment or replevin, generally do not bear fruit because the merchandise has been disposed of. And the bust-out operator has likely disappeared. Even if the bust-out operator can be tracked down, he or she usually does not have any easily traceable assets to satisfy a judgment. A vendor may be able to establish other claims against the operator, such as breach of fiduciary duty (where the operator is an officer of its company) or RICO claims. Again, however, these claims usually do not put money back in the vendor's pocket. They can be expensive to develop.

A vendor's strongest legal rights may be those against the buyers of the discounted goods. If a vendor can identify its goods that are in the hands of a buyer who has purchased from a bust-out operator, and the vendor can establish that the buyer did not purchase the merchandise in good faith (i.e., the buyer knew or should have know the transaction was fraudulent and thus was not a bona fide purchaser), the vendor may have a claim against the buyer.

When the business failure includes a bankruptcy filing, a vendor's legal remedies are also limited. The vendor may be able to convince the bankruptcy trustee of the failed business to pursue the buyers of the discounted merchandise under a fraudulent conveyance theory. The trustee would, however, need funding to pursue such litigation. A vendor may attempt to block the discharge of its claim in the bankruptcy by filing a complaint to determine the dischargability of its debt where the operator has filed an individual bankruptcy. In either situation, the vendor still faces the problem of locating the operator's assets.

Another means of combating a bust-out is to refer the bust-out to the United States Attorney's Office, the District Attorney, of if the case is in bankruptcy, the Office of the Untied States Trustee. The U.S. Trustee is an adjunct of the Justice Department and has the responsibility of working with the U.S. Attorney's Office to investigate bankruptcy crimes. The Bankruptcy Reform Act of 1994 established new criminal penalties for any person fraudulently using a bankruptcy filing to discharge debts.

The warning implicit in the WSJ article is that credit executives must be especially vigilant when furnishing credit to new accounts. Credit executives must closely monitor existing accounts for the red flags mentioned above. Perhaps these steps will help the credit executive avoid selling into a bust-out -- and joining the ranks of defrauded vendors.

MAKE CLEAR WHO IS GUARANTYING YOUR DEBT (Continued)

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> full performance and observance of all covenants, conditions and agreements therein provided to be performed and observed . . ."

The guarantor testified that the parties never discussed whether he would be personally liable under the guaranty. The fast food company filed bankruptcy. The fast food company assigned its rights under the long term agreement to a related company, whose president was the same individual. This new company likewise defaulted on the agreement.

The creditor sued the guarantor on the guaranty. The guarantor asserted he had not personally obligated himself to the agreement as he had signed the guaranty in a representative capacity (as president for the related company). The guarantor contended the lack of evidence of mutual intent by the creditor and himself in the language of the guaranty or in the interactions of the parties could only mean that no contract was formed, and thus there was no binding guaranty.

The court framed the issue as whether a person using a representative title (for example, president) prevents a signer from becoming personally bound under a guaranty where there is no evidence of intent on the face of the guaranty or in the parties' interactions, but the only possible purpose of the guaranty is to provide a personal guaranty.

Principles of Contract Control

In *Wilson Court*, the guaranty did not name the guarantor. The guaranty also did not indicate that the party signing was to be personally bound. The general rule is that when the signer's identity is otherwise clear from the face of the contract, the title appearing after the signature is merely a personal descriptor, and does not prevent personal liability from attaching. Nor was there any evidence between the parties that the creditor intended to bind the individual on a personal basis.

The court resolved that because there was an apparent conflict between the guaranty and the parties' interpretation, the court may go outside the four corners of the guaranty and resolve the ambiguity by introducing evidence of the prior negotiations to show that the terms of the guaranty were other than those on the face of the agreement. The court attempted to determine the intent of the parties not only from their interactions and from the language of the guaranty, but the purposes of the guaranty.

The court observed the guaranty was enforceable:

> "[The President] contends that the lack evidence of mutual intent in the language of the documents or in the interactions of the parties can only mean that a contract was not formed. But the very nature of the a guaranty is to undertake primary obligation for the performance of another."

In other words, because the corporation could not guarantee its own obligation to the creditor, the very act of creating a guar-

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CONSIGNMENT CREDITORS BEWARE: COMPLY WITH THE UCC OR RISK LOSING YOUR GOODS (Continued)

(continued from page 1)

The notice should describe the merchandise.

A consignor must give notice to any creditor asserting a security interest in the debtor's inventory in order to avoid any appearance that inventory coming to the consignor-debtor is free from ownership claims. This notice also distinguishes the "new" merchandise on consignment from other inventory that is subject to the after-acquired property clause contained in the creditor's security agreement. The consignor that takes these steps is entitled to the identifiable cash proceeds from the sale of its merchandise, or to the return of the merchandise itself.

To have priority in the accounts receivable generated by the sale of consigned goods, the consignor must also comply with the UCC notice filing requirements as to accounts receivable.

If there is a pre-existing creditor, and the consignor has failed to give notice in the manner just described before he consignee received possession of the inventory, then the consignor has failed to perfect its interest in the consigned merchandise. Its priority in receipt of payment is thereby governed by the "first to file" rule. This means that a pre-existing, inventory secured creditor's lien would take priority over a consignor's security interest.

Debtor Known To Sell On Consignment

An exception to the consignor's need to comply with the UCC Article 9 notice requirement, and a key issue in *Thorton-Blue Pacific*, is where the debtor is generally known by its creditors to be engaged in consignment sales. However, in a priority fight with a competing creditor or trustee over the same collateral, it is a heavy burden for a consignor to convince a court that the debtor's creditors indeed knew that the debtor was engaged in selling the goods of others on consignment.

Informal Consignment Arrangements

In *Thorton-Blue Pacific*, the debtor was a flower wholesaler. The party contending a consignment arrangement (the consignment creditor) with the debtor was a grower. The debtor marked the flowers with its own name, packaged the flowers and sold them to retail florists. The price and terms of sale were determined by the debtor. If the flowers were sold and the debtor received payment, it remitted 75 percent of the sales price to the consignor and retained 25 percent as its commission.

If the flowers were not sold, the consignor received nothing. The debtor incurred no risk other than its costs of doing business. The consignor had not complied with the terms of the UCC to perfect its interest; the parties had not entered into any agreement stating that the creditor was a consignor and the debtor was a consignee, or that the consignor's flower inventory was delivered on consignment.

Prior to entering the supposed consignment arrangement, the debtor guaranteed a bank loan on behalf of its three shareholders. The bank was granted a security interest in the debtor's assets, including proceeds from the sale of the debtor's flower inventory. The shareholders defaulted on the loan, and the bank sued the shareholders, together with the debtor. The debtor negotiated a settlement with the bank by offering the proceeds from the sale of flowers which were held in a bank account. The consignor objected to the settlement, contending that a significant portion of the cash in the account originated from the sale of its flower inventory and that the consignor had priority to the proceeds by virtue of a consignment arrangement with the debtor.

The trial court ruled that the bank had a superior right to the proceeds, and denied the claims of the consignor. The consignor appealed.

Risk Of Loss On Consignment Creditor

On appeal, the consignor made three arguments intended to prime the bank's interest in the cash. First, the debtor was generally known by its creditors to be engaged in consignment sales, and for that reason the consignor was excused from complying with the notice requirements of the UCC.

As to the consignor's first argument, the bank stated it was unaware that the debtor was selling goods on consignment. The only evidence presented by the consignor on this point was two affidavits from other consignors of the debtor, stating that they had consignment arrangements with the debtor. The consignor did not offer any evidence from other, non-consigning creditors that they were aware the debtor was selling anything on consignment.

The court observed that when non-consigning creditors know of a debtor's consignment arrangements with other creditors they can take precautions to protect their open account sales. That is the reasoning behind excusing a consignor from complying with the UCC's notice provisions. From the non-consigning creditors view, consignment arrangements were undisclosed -- the infamous "secret liens" that the drafters of the UCC loathe. Such undisclosed arrangements take proceeds from the debtor's sales that otherwise would be used to pay unsecured creditors.

The consignor further argued that because the sale of flowers to the debtor was on consignment, the debtor never had title to the flowers. Therefore, the bank's security interest could not attach to the consignment creditor's flowers, or the proceeds from the sale of the flowers. And it argued that the bank had a senior claim only to the flowers in the debtor's possession, and not to the proceeds received upon the sale of those goods.

The court disagreed, stating that the consignor became an unsecured creditor upon the sale of the inventory and had no priority claim to the proceeds unless it had complied with the perfection requirements of Article 9. The court determined that by virtue of security agreement and financing statement, the bank had a security interest in the proceeds of the sale of the flowers.

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CONSIGNMENT CREDITORS BEWARE: COMPLY WITH THE UCC OR RISK LOSING YOUR GOODS (Continued)

(continued from page 8)

Comply Or Risk Losing Your Goods

The *Thorton-Blue Pacific* ruling reminds creditors considering consignment sales that such sales are more than mere “sale or return” transactions. When a party delivers merchandise to a customer to sell, but with the right to receive back the unsold merchandise, the transaction is nothing more than a sale, thus making the selling party (who believed it was a consignment creditor) merely a general unsecured creditor. Since adoption of the UCC, consignment sales have changed. Failure to comply with the notice provisions of the UCC puts the consignor’s inventory at risk to existing and subsequent inventory lenders, unsecured creditors’ committees and a bankruptcy trustee, e.g., while the non-perfected consignor waits for its inventory to be sold, creditors may rush in and levy this inventory to satisfy their claims.

The *Thorton-Blue Pacific* ruling emphasizes that the exception to complying with the UCC’s Article 9 (when the debtor is generally known by its creditors to be engaged in consignment sales) is a difficult thing for a non-filing consignor to establish. Should you find yourself in a dispute with a creditor or a trustee who asserts ownership of your inventory, or proceeds from that inventory, and you have not complied with the UCC, obtain as many affidavits from non-consigning creditors as possible, attesting that the non-consigning creditor was aware that the debtor was engaged in consignment sales.

The intent of the UCC is to compel a consignor to comply with the filing statutes. The UCC is not out to destroy consignment transactions, only secret liens. Unrecorded consignment agreements are viewed as “secret liens” and are disfavored as they do not give general creditors the opportunity to protect themselves. Creditors of a debtor in a “sale or return” transaction naturally conclude that goods held by a debtor belong to the debtor. Consignment sales that do not create a hidden lien are to be left alone. Thus, the publicized consignment sale is protected. However, as *Thorton-Blue Pacific* makes clear, consignors have a heavy burden in establishing a sale is indeed sufficiently publicized. Thus, the only real option for a consignment creditor is to comply with the UCC’s Article 9 filing provisions.

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2. 97 Daily Journal D.A.R. 3897 (1997).

PRINTER CANNOT COLLECT AS JOINT VENTURER (Continued)

(continued from page 3)

The court observed that the Printer had reviewed the Publisher-Customer contract before agreeing to print cookbooks. That contract stated that the contracting parties were not joint venturers and that the Publisher had no authority to create obligations on behalf of the Customer.

The court also noted that the Customer controlled the essentials of the publication, including the number of cookbooks to publish and what recipes to include.

Steps To Assure Payment

One step the Printer could have taken to assure payment of its open account sales before beginning the job was to have obtained a security interest in the proceeds from the sale of the cookbooks. Had the Printer taken a security interest, it would have had a right to payment that was superior to rights of the Customer.

Alternatively, the Printer could have contracted with both the Publisher and the Customer for payment of its claims. Such a contract would have provided that the Publisher was obligated to turn over the proceeds from the sale of the cookbooks to the Printer first.

Credit executives at commercial printers would do well to examine a worst-case scenario when considering the size of production runs allowable under contracts they are evaluating. Contracts establishing print runs so big that they are likely to create a large account receivable should be examined with a creative eye. Obtaining a security interest in the proceeds of the product or negotiating a contract to bind the customer’s partner may be well worth the extra effort it takes.

1. *Ringer America, Inc. v. Land O’Lakes, Inc.*, 1997 U.S. App. Lexis 2026 (8th Cir. 1997).
2. *Ringer America* at 2026.
3. *Ringer America* at 2030.

SECTION 547(C)(4): MUST THE NEW VALUE REMAIN UNPAID? (Continued)

(continued from page 4)

unsecured credit, such credit could be used to offset a preferential transfer. Section 60c required that subsequently advanced credit remain unpaid at the time of filing of the bankruptcy petition. The perceived inequities of this section were revealed, however, with a Supreme Court decision holding that the preference section in effect required a preferred creditor to surrender all of its preference payments, both avoidable and unavoidable, before its claim would be allowed.

To combat this harsh result, a number of courts established the so-called "net result rule" holding that when goods were sold and payments made on a running account during the preference period and the net result of the total sales less the total payments was the enrichment of the debtor's estate, the transfers were not preferential. Under the net result rule, bankruptcy courts simply totalled the preferential payments and the subsequent advances during the preference period and offset them against each other (contrasted with the subsequent advance rule which protects preferential transfers only to the extent the new value is provided after the transfers are made).

Despite legislative history stating that the subsequent advance rule was a codification of the net result rule, a number of courts now have determined that the net result rule did not survive enactment of the 1978 Bankruptcy Code in light of the subsequent advance rule's timing requirement.

III. THE MAJORITY RULE:

THE SUBSEQUENT ADVANCE MUST BE UNPAID TO SATISFY § 547(C)(4)

In addition to the elements of the subsequent advance rule, as set forth above in section II, those courts following the majority rule paraphrase the language contained in §547(c)(4)(B): "on account of which new value the debtor did not make an unavoidable transfer to or for the benefit of such creditor" and require that the subsequent advance must remain unpaid. The inquiry posed is whether the creditor replenished the estate after having received a preferential transfer. These courts equate replenishment with the subsequent advance providing the estate with a material benefit.

A subsequent advance in an amount equal to the preference "in effect returns the preference to the estate." However, where a debtor pays the subsequent advance (or the creditor retains a security interest in the advance) there is no return of the preference and the estate is not benefitted. In other words, the creditor has been paid more than it has supplied the estate, and this difference is subject to recapture by the trustee under the majority rule.

Permitting an offset for paid new value frustrates Congressional policy of equality of treatment of similarly situated creditors. In *PNP Holdings*, the bankruptcy court held that if a creditor is able to claim the subsequent advance as an offset to the preference, this creditor would fare better than its fellow preference defendants. The creditor would not have to forfeit the preference, and it would already have been paid for goods it furnished to the debtor during the preference period after it received the preference.

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

Moreover, several of the courts following the majority rule conclude that adhering to a policy that the subsequent advance need not remain unpaid seems contrary to common sense. As one bankruptcy court noted:

> "The majority rule on this issue is indeed the one which makes sense. Allowing the offset of a satisfied subsequent advance may give lip service to the statutory goal of encouraging continued dealings with distressed business, but it does so at the cost of tipping the statutory balance of economic considerations over to the creditor-supplier's side . . . This makes every bit of sense [adoption of the majority rule]; the subsequent advance no longer remains an unpaid receivable on the creditor-supplier's books, so there is no reason why it should get 'credit' for it in the larger-scale adjustment of relationships which takes place in the avoidance of preferences."[4]

IV. THE EMERGING VIEWPOINT: THE SUBSEQUENT ADVANCE NEED NOT REMAIN UNPAID

A minority of courts reject the majority rule, including most recently the Ninth Circuit Court of Appeals, permitting application of the subsequent advance rule where the creditor has been repaid by the debtor, unless the debtor repays the subsequent advance by a transfer which is otherwise unavoidable. These courts look to various factors to support their rationale, including the plain language of the statute and detailed analysis of legislative history and policy supporting the preference provision.

Courts adhering to the emerging viewpoint find that the plain language of § 547(c)(4)(A) and (B) does not require that the subsequent advance remain unpaid. Rather, these courts hold that § 547(c)(4)(B) clearly requires only that the debtor not make an "otherwise unavoidable transfer" on account of that advance.

Where the debtor does not make such an "otherwise unavoidable transfer," the subsequent advance should be available as a set-off against the preference. This means that a transfer could escape the definition of a voidable preference by failing to satisfy that section's requirements or by falling within one of the seven preference exceptions. If the subsequent advance is met with a transfer to the creditor that is unavoidable, the subsequent advance is unavailable for offset.

As the Ninth Circuit stated in *IRFM*:

> "[A]ssurance must be given that the creditor will not attempt to

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SECTION 547(C)(4): MUST THE NEW VALUE REMAIN UNPAID? (Continued)

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> obtain double credit for a transfer. This requirement may be satisfied by disallowing a creditor from asserting a separate section 547(c) defense against a preference when the creditor has already used section 547(c)(4) to offset that preference."[5]

Or, alternatively, the Ninth Circuit noted a creditor "may file a waiver of all other preference defenses or may also stipulate to the avoidability, other than under section 547(c)(4), of all transfers it received from the debtor except those made after the last transfer of new value."[6]

Notwithstanding the Supreme Court's directive that where a statute's language is unambiguous a court need not resort to legislative history, many of the courts adopting the emerging viewpoint consult such history. These courts note that the legislative history to § 547(c)(4) is equally devoid of language requiring the subsequent value to remain unpaid. Indeed, the Garland bankruptcy court discussed the fact that when Congress drafted § 547(c)(4) it deleted the express language under the Bankruptcy Act requiring that the subsequent advance remain unpaid.

1. © *California Bankruptcy Forum*. This article first appeared in the 1997 Edition of the California Bankruptcy Forum. A footnoted copy of the article provided upon request.

2. *IRFM*, 52 F.3d at 231.
3. *Id.*
4. *IRFM*, 52 F.3d at 233.

5. *IRFM*, 52 F.3d at 233 n.6 (citing *Check Reporting* at 438).
6. *Hancock-Nelson Mercantile*, 122 B.R. at 1016-17.

MAKE CLEAR WHO IS GUARANTYING YOUR DEBTS (Continued)

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anty is evidence of the parties' mutual intent to bind the President personally.

Is Your Guaranty Complete?

As credit executives are well aware, a guarantor will always attempt to find ways to challenge the validity of his or her guaranty. The *Wilson Court* case reminds credit executives that the guarantor is not a party to the principal debt. The guarantor's undertaking is independent of the debtor's promise to pay. Merely because both contracts are on the same paper -- the debtor's promise to pay for the vendor's goods or services, and the guarantor's promise to pay if the debtor does not -- does not change the independence of the agreements.

The *Wilson Court* case reminds credit executives that the language in the guarantee should clearly express that the particular individual signing the guaranty is agreeing to answer for the debt of another. Using a form guaranty that fails to identify the guarantor and the capacity that the guarantor is signing may open the door for needless legal challenge by the guarantor.

SUBORDINATING A SELLING SHAREHOLDER'S CLAIM (Continued)

(continued from page 5)

sible and the selling shareholder would be placed on a parity with trade claims.

However, the court also found that, under the "supremacy clause" of the U.S. Constitution, the Bankruptcy Code is a federal statute and so preempted state corporate law. The subordination provision of the Bankruptcy Code was in direct conflict with state law here, as (1) the Bankruptcy Code required subordination of the claim while state law provided for parity; and (2) bankruptcy policy promotes a fair distribution to unsecured creditors even though state law does not consider such issues.

As the court was not imposing liability upon the corporation's directors who authorized the stock buy-out agreement but instead was subordinating a claim based essentially on a dividend when the corporation is insolvent. Therefore, there was nothing fundamentally unfair with the court's ruling.

Vendors' Protections

Shareholders in closely held corporations may face legal challenges from trade creditors attempting to unwind stock repurchases on several fronts, including the following scenarios: (1) If a corporation makes a distribution while insolvent, or a distribution impairs its capital, the transaction may be attacked under state law; and (2) When a stock redemption provides for delivery of a promissory note by the corporation, the balance owed on the promissory note may be equitably subordinated later, should the corporation file bankruptcy.

CASHING CHECK NOT ACCORD AND SATISFACTION (Continued)

(continued from page 2)

owed.

The debtor had attempted to resolve the account dispute by paying less than the amount contended by the vendor. The debtor remitted checks to the vendor dated June 17 and August 18. Tendered with the checks were vouchers stating "Paid in full" through particular dates. The vendor, however, contended it was still owed $58,000.

The debtor met with a new employee of the vendor. The debtor reported that the two parties had, in a previous meeting with a former employee reached agreement to settle the delinquent account. After holding the June 17 check for several months, the vendor cashed the check, crossing out the words "Payment in full" and "Full statement of account to follow." The vendor added the notation "Without prejudice." The vendor cashed the August 18 check in the ordinary course of its operations. The vendor's accounting manager contended that she did not notice the "Paid in full" notation on the voucher. The vendor demanded the balance due from the debtor.

The debtor sued the vendor for declaratory relief contending that it effected an accord and satisfaction of its debt by tendering the checks with the vouchers. The vendor countersued seeking payment for the balance owed. The trial court ruled in favor of the vendor, finding that the debtor owed the arreages. The debtor appealed.

The General Rule

The court analyzed the checks. The debtor's contention was that notations on the checks implying full satisfaction of the debt were conspicuous. The debtor also contended that the vendor understood that the checks were meant to fully satisfy the debt. Accordingly, the debtor argued, there was an accord and satisfaction of the debts.

The court cited the general rule:

> "where [an] amount due is in dispute, and the debtor sends [a] check for less than the amount claimed, clearly expressing that it is sent as settlement in full . . . [the] cashing of the check is almost always held to be an acceptance of the offer operating as full satisfaction."[2]

Good Faith Dispute

A good faith dispute between the parties is a prerequisite to an accord and satisfaction. In other words, the party seeking to establish an accord and satisfaction by tendering a check must do so in good faith. Under the UCC good faith is defined as honesty in fact. The court observed the nature of a good faith dispute:

> "The debtor's mere refusal to pay the full claim does not make it a disputed claim. Where the refusal is arbitrary and the debtor knows it has no basis, the payment of less than the full amount claimed does not operate as an accord and satisfaction even though it is tendered and received as such."[3]

The court found that in this case, there was no honest dispute between the debtor and the vendor when the debtor tendered a check to the vendor. A debtor's open refusal to pay a debt is not enough to establish a god faith dispute. The debtor must demonstrate a just basis for refusing to pay. The court ruled that the debtor had purposefully misled a new employee of the vendor who met with the debtor. At that meeting, the debtor represented that the account had been settled. Because the debtor was taking advantage of the vendor at the time of tendering payment, the debtor failed to meet the good faith requirement of the UCC and, thus, there was no accord and satisfaction.

Clearly Intend to Settle Dispute

Before a check can manifest an accord and satisfaction, the party who presents the check must make it clear that cashing the check is intended to settle all outstanding accounts between the parties. While the debtor's August 18 check bore the notation "Paid in full", the restrictive note was the last of several lines of information inscribed on the voucher accompanying the check. The voucher referenced three invoices. The court ruled that the debtor had failed to make it sufficiently clear that depositing the check would settle all outstanding disputes. It was not clear that the check was not intended merely to settle the invoices referenced in the voucher.

The vendor's accounting clerk stated that she did not see the "Paid in full" reference before the cashing the check. The court determined that even if the "Paid in full" language was clear, the accounting clerk for the vendor was never advised by the debtor of the significance of the phrase, "Paid in full." Nor was there evidence that the accounting clerk had responsibility to any accord and satisfaction which the vendor might reach with its debtors. The UCC is intended to prevent an accord and satisfaction from mistakenly taking place when a check is sent to a collection center for a large organization and is cashed without inspection. A debtor cannot unilaterally create an accord and satisfaction.

Words of Protest

It should be noted that had there been a good faith dispute, the vendor's cashing the check would have served as an accord and satisfaction:

> "Assuming there was an accord, [vendor's] bid to prevent a satisfaction by accepting the check but scratching out the restrictive endorsement and adding the words 'without prejudice' before he cashed the check was to no avail, for under the revised version of the U.C.C., words of protest cannot change the legal effect of an accord and satisfaction."[4]

Lesson Learned

Before a check can create an accord and satisfaction, the party who presents the check must make clear -- by appropriate and conspicuous wording -- that cashing the check will be construed as settlement of all outstanding claims between the parties. Such notation can take the form of a debtor writing on the check, or accompanying

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CASHING CHECK NOT ACCORD AND SATISFACTION (Continued)

(continued from page 12)

voucher: “Payment in full settlement of the stated accounts” or “Endorsement of the check constitutes a complete settlement of your claim” in conspicuous letters.

Under the UCC, a party may avoid an accord and satisfaction by returning the money within ninety days. A party’s bid to prevent a satisfaction by accepting the check but scratching out the restrictive endorsement and adding the words “without prejudice” is of no avail. Under the UCC, words of protest cannot change the legal effect of an accord and satisfaction once a check has been cashed.

The UCC provides for prevention of an accord and satisfaction mistakenly taking place. Sometimes checks are sent to an automated collection center of a large organization and are cashed without inspection. A creditor may require that, to be effective, any attempted accord and satisfaction must be sent to a particular office. Vendors should be mindful that certain states may have adopted variations of the UCC which would impact the outcome of such cases.

1. *McMahon Food Corp. v. Burger Dairy Co.*, 103 F.3d 1307(7th Cir. 1997)
2. *McMahon Food Corp.*, 103 F.3d at 1315.
3. *McMahon Food Corp.*, 103 F.3d at 1317.
4. *McMahon Food Corp.*, 103 F.3d at 13012.