Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

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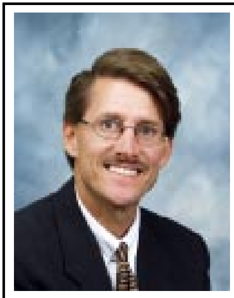
Developments in Commercial, Creditors' Rights, E-Commerce and Bankruptcy Law of Interest to the Credit and Financial Professional

THE SUPREME COURT DECISION OF BANK OF AMERICA V. 203 NORTH LASALLE PARTNERSHIP: AUCTIONING AN INSOLVENT DEBTOR'S EQUITY FOR THE BENEFIT OF UNSECURED CREDITORS



Scott Blakeley

In a much anticipated decision by credit industry groups, on May 3, 1999, the Supreme Court in *Bank of America v. 203 North LaSalle Partnership* considered whether shareholders of a Chapter 11 debtor may confirm a plan of reorganization that gives equity holders the exclusive right to retain their shareholder interest postbankruptcy if they contribute cash, even though unsecured creditors are not paid in full. The case concerns the absolute priority provided in Chapter 11 of the Bankruptcy Code and the so-called new value exception to this rule

The Supreme Court, which rarely considers bankruptcy issues, ruled that a Chapter 11 debtor's equity holders must auction their equity interest to the highest bidder where they propose a plan of reorganization that allows them to retain their equity interest and unsecured creditors are not paid in full. The Supreme Court's decision and the Chapter 11 plan of reorganization process as it may impact vendors is considered.

I. The LaSalle Street Partnership *Case*

The debtor partnership owned an office tower secured by a $93 million mortgage. The debtor was unable to service the bank obligation, and the bank began foreclosure proceedings. The debtor filed for Chapter 11 to stay the bank's foreclosure. The debtor proposed a plan of reorganization that provided for splitting the bank's claim into a $54 million secured claim and a $38 million unsecured claim. The plan proposed to pay 16% on account of the unsecured claim. The plan gave the equity holders the exclusive right to retain their shareholder interest in the postbankruptcy debtor if they contributed cash of $4 million, payable over five years.

The bank objected contending that the debtor's plan of reorganization violated the absolute priority rule, as unsecured creditors' claims must be paid before equity can retain property under a reorganization plan. The bank complained that the new value contribution by the equity holders violated basic principles of bankruptcy law as it permitted those at the bottom of the priority ladder, shareholders, to control the debtor to the detriment of unsecured creditors, who have a higher priority.

The Supreme Court reversed the Circuit Court of Appeal. The Supreme Court ruled that the debtor's shareholders may not, over the objection of unsecured creditors, contribute new capital to retain their shareholder interest unless there is opportunity for others to compete for the purchase of the equity of the debtor.

II. Payment of Vendors in Chapter 11: The Plan of Reorganization Process

In Chapter 11, vendors may be paid on account of their prepetition claims only through a Plan of Reorganization (Plan). The Bankruptcy Code and Rules and cases imposes certain procedures and standards before a Plan may be confirmed and vendors paid.

A. The Exclusivity Period

A debtor has the exclusive right to file a plan of reorganization during the first 120 days, and upon the filing of a plan, the exclusivity period is extended an additional 60 days. A debtor may seek to extend the exclusivity period, for "cause". A bankruptcy court may grant a debtor's request to extend exclusivity if the debtor demonstrates meaningful progress of the Chapter 11 case.

B. The Disclosure Statement

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THE BANKRUPTCY REFORM ACT OF 1999: WHAT IT MAY MEAN FOR VENDORS

Scott Blakeley

Spring has arrived and the United States Congress is again considering reforming the nation's bankruptcy laws. Congress came close to passing bankruptcy reform last year with legislation passing both Houses of Congress. The Senate voted in favor of reforming the Bankruptcy Code last year, in part, in an attempt to reduce the upsurge in personal bankruptcies. However, the bankruptcy reform bill last year was prevented from being finally voted on because of the impeachment proceedings and opposition from the President and some in Congress to the "means testing" provision for consumer debtors. During February and March, 1999, bankruptcy reform legislation was again introduced to the House of Representatives and the Senate (the 1999 Bankruptcy Legislation). The 1999 Bankruptcy Legislation contains a number of proposed commercial and consumer law changes. What does the proposed bankruptcy reform legislation mean to vendors? Below is a summary of some of the important points that may affect vendors.

A. Rewriting The Preference Laws

The 1999 Bankruptcy Legislation proposes three points to reform the preference laws.

1. What Is A Preference?

The Bankruptcy Code vests a bankruptcy trustee with far-reaching powers to avoid payments to vendors and other creditors within 90 days prior to the bankruptcy filing (one year for insiders). The Bankruptcy Code defines a preference expansively to include nearly every payment by an insolvent debtor 90 days prior to bankruptcy. The purpose of the preference laws are two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, a debtor is deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of a debtor's assets.

2. The Bankruptcy Review Commission Recommends Changes To The Preference Laws

The Bankruptcy Reform Act of 1994, wherein Congress overhauled the Bankruptcy Code, created a nine-member bankruptcy commission to make recommendations on whether further reform of the bankruptcy laws were necessary. The Commission found that the preference laws lead to abusive preference suits by bankruptcy trustees who bring actions often without analyzing a vendor's defenses, and to extract settlements from vendors because of costs to defend these actions.

3. Minimum Threshold To Sue For A Preference

Receiving a preference complaint by a

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FROM THE PUBLISHER:

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

Guest Column

REVISE PREFERENCES

Douglas G Fox, CCE

Mannesmann Rexroth Corporation

One of the problems facing business credit managers today is that efforts to help a troubled debtor may backfire later due to preference issues. This is often the case where the sale is taking place on unsecured terms, as does much of the commerce in America today.

Generally speaking, when a debtor stops making payments on time, most credit managers that I know place the debtor on shipping hold. The concept is fairly simple. If the debtor is unable to pay his bills on time at a certain level, why incur greater cost (by becoming an unwilling source of often free working capital) and increased risk of financial loss (possible bankruptcy) at a higher level of credit extended?

Despite this general concept, circumstances often arise where a creditor's products and/or services are of such crucial importance to the successful operation of the debtor's business, that the debtor may fail if the flow of supply is interrupted or terminated.

For example, this may occur with specialized or technological equipment where the creditor's product is an integral part of the debtor's product. In the event that the creditor terminates shipments, the debtor will eventually get to the point where its products can no longer be manufactured.

Although in this era of world wide competition there is usually alternative sources of supply, sometimes other considerations (such as time, delivery, price, and quality) prevail. The result is that the debtor finds itself in dire straits on short notice. Further, other sources may not be willing to extend credit due to the debtor's deteriorating payment record as reported by credit agencies.

Creditors often try to work along with the debtor during these difficult financial times. However, doing so may create greater risk.

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BATTLING FOR THE PROCEEDS REVISITED: VENDOR MUST DISGORGE PAYMENTS TO DEBTOR'S LENDER

Scott Blakeley

A sophisticated credit executive is well aware of the credit risks of selling on open account. A significant risk may be that the debtor defaults on its financing agreement with its lender, whose lien encumbers all of the debtor's assets including inventory and the proceeds from the sale of the inventory. The lender, as provided for in its security agreement, may foreclose and sell the vendor's goods located at the debtor's business to satisfy its secured claim. Or, if the debtor has sold the vendor's goods and holds the proceeds, the lender claims it has a security interest in the proceeds. What steps should a credit executive take to protect its credit sales in the face an inventory lender?

A recent edition of Business Credit published my article "BATTLE FOR THE PROCEEDS: PREVAILING ON YOUR PURCHASE MONEY SECURITY INTEREST, DESPITE A POST-DATED CHECK", which reported the success of a vendor battling a lender over priority of sale proceeds of the vendor's goods. The vendor established a valid purchase money security interest (PMSI), and priority to the proceeds. In the recent decisions of In re Win-Vent (Commerce Bank v. Tifton Aluminum Company, Inc.)[1], a vendor was not so successful in a priority fight with the debtor's lender's over sale proceeds. The vendor was unable to establish a valid PMSI, and the lender prevailed. We will consider these decisions.

The Lender Forecloses On The Debtor's Assets

The debtor manufactured aluminum windows. The vendor supplied the majority of the debtor's raw materials on open account. Thereafter, the debtor entered into a financing agreement with a lender to finance its inventory. The lender took a security interest in the debtor's assets, including inventory, accounts receivable, proceeds from accounts receivable, furniture, equipment and collateral to be acquired by the debtor in the future--the so called "floating lien" that permits a lender to capture after-acquired collateral, or the proceeds from the sale of the collateral, upon a debtor's default.

The debtor defaulted on the vendor's open account. The vendor and the debtor agreed that the debtor would pay 30% of its receivables to the vendor on a weekly basis. The vendor then required COD sales.

The lender began foreclosing on the debtor's assets. The debtor moved its bank accounts to avoid the lender from foreclosing on the cash in which the lender had a security interest. The debtor advised the vendor it had moved its bank account to attempt to avoid the lender's lien. The debtor paid the vendor nearly $1 million on its delinquent account out of the newly opened account until the debtor stopped operating. The source of the vendor's payments was from the debtor's collections of accounts receivables in which the lender claimed a security interest. The debtor filed Chapter 11 bankruptcy, which was converted to Chapter 7 liquidation.

Lender Sues Vendor

The lender sued the vendor, contending that the vendor received payments of nearly $1 million from the debtor and the source was from the proceeds of accounts receivable in which the lender had a security interest. The lender presented letters showing that the vendor was aware of the lender's claimed security interest in the debtor's cash.

The vendor countersued, contending that it was entitled to keep the payments from the debtor based, among other things, that it had a valid PMSI in the $1 million it received, that the lender had defrauded the vendor and that the lender would be unjustly enriched if the vendor was required to return the payments as the vendor's con-

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PLAYING "CATCH UP" WITH A PREPRETITION CLAIM CAN BE COSTLY FOR VENDOR

Scott Blakeley

One of your favored accounts files Chapter 11 bankruptcy, leaving you with a large open account balance. The debtor requests you sell postbankruptcy, contending that the Chapter 11 company will reorganize and needs your product to do so. Do you sell to the debtor in possession? Selling a debtor in possession has certain opportunities and protections to a vendor, including an administrative claim should the debtor default on a postpetition sale. However, for an overzealous vendor who views postpetition sales as an opportunity to mark-up postpetition invoices to "catch up" and reduce its prepetition claim, with the debtor's consent, may spell trouble. A bankruptcy court, In re Centennial Textiles, Inc. (227 B.R. 606), recently considered a vendor's liability where it allegedly submitted inflated invoices for postpetition services (priced at 68% above prepetition invoices), including whether the vendor should be liable for the company's losses under a theory of conspiring to aid and abet the debtor's breach of fiduciary duties.

The Vendor Provides Postbankruptcy Services

The debtor converted raw materials into finished goods in the textile industry. The vendor was a key supplier of the debtor. The debtor filed Chapter 11, and the vendor had a significant prepetition claim for services rendered. Postpetition, the vendor provided processing services to the debtor. The debtor was unable to reorganize under Chapter 11 and the case was converted to a Chapter 7 liquidation.

The Vendor Allegedly Increases Prices with Postpetition Sales to "Catch Up" on Prepetition Claim

The bankruptcy trustee appointed to the bankruptcy case sued the vendor to recover postpetition payments by the debtor

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A BUST-OUT WITH A HAPPY ENDING FOR VENDORS (IN THIS CASE)

Scott Blakeley

A frustrating aspect of a credit executive's job is being ensnared in a planned insolvency or bust-out. Even a sophisticated credit executive who may sense credit risk with a particular account, and sell only on COD, may find a debtor's check bounce and that the goods delivered to the debtor vanish (along with the proceeds from the sale of the goods). In a recent success story, vendors ensnared in a recent bust-out in Southern California acted swiftly and worked closely with local law enforcement, and, with the assistance of NACM's fraud prevention unit and NACM-affiliate Credit Managers Association of California, tracked down and recovered the goods. A criminal investigation is pending against the bust-out operators. The story is instructive for credit executives.

The Bust Out

A bust-out is a scheme devised to defraud vendors of their goods through the use of planned insolvencies, bankruptcies and business failures. The bust-out operator obtains goods on credit purchases with the intent of not repaying the debts. 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 a bust-out operator 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 attempts to establish good credit, and credibility, with vendors. The bust-out operator often chooses a company name sounding much like a well-established company to further add credibility. 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 is often limited, while increasing competition in many fields has pushed large numbers of vendors to relax their credit standards. Unsuspecting vendors of any size are vulnerable to bust-out schemes. The bust-out operator takes possession of the goods, 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 simply disappears with the cash. Far from being experienced businessmen who have stepped over the line in their business decisions, a bust-out operator is usually a member of criminal ring that operates for the sole purpose of defrauding vendors.

The Bust Out In Action

Abandoning the Business and Transferring Vendors' Goods

A number of major food manufacturers sold goods on open account to two local distributors, who are referred to as the Distributors. The Distributors would then supposedly resell the goods to speciality retailers. The Distributors operated out of a leased warehouse. The Distributors had submitted credit reports indicating reliable credit and a long-term business history to vendors. Based on these reports, they obtained credit from vendors. The Distributors made some "prime the pump" payments to vendors to establish their credit references. In August and September, 1998, the Distributors placed large credit orders with vendors.

Over a weekend in September, 1998, the Distributors transferred all of their assets, including the vendors unpaid goods, to a related distributor referred to as the Acquiring Company. The Acquiring Company's principal stated that he obtained the vendors' goods through a going out business sale. The Acquiring Company wire transferred several hundred thousand dollars out of the country to the Distributors' account.

Vendors were never notified of the transfer of goods. The vendors went unpaid. Within days of conveying their assets, the Distributors shut their doors and abandoned their location without notice to vendors. The manager of the Distributors was the same for the Acquiring Company. The manager had an alias name while at Acquiring Company. The Acquiring Company hired two other employees of the Distributors. The Acquiring Company transferred several hundred thousand dollars to an overseas account. The Acquiring Company operated out of a different leased warehouse. Other than the inventory received from the Distributors, the Acquiring Company did not receive any other goods to operate its business. Its sole operations were distributing the goods received from the Distributors.

NACM'S Fraud Prevention Unit Takes Action

With the Distributors unexplained closing, NACM members began calling NACM's Fraud Prevention Unit. The Fraud Prevention Unit issued advisory bulletins of the bust-out and steps vendors must take with the court to recover their goods seized by the sheriff.

The Sheriff's Department Takes Action and the Goods are Seized

The Los Angeles County's Sheriff's Department, through its Commercial Crimes Bureau's Forgery/Fraud Unit, was contacted by vendors of the suspicious closing of Distributors. A detective from the Bureau was assigned to investigate a potential criminal fraud regarding the circumstances leading to the appearance of goods at the Acquiring Company's warehouse. Based on tips supplied by vendors of the suspicious closing of the Distributors and the transfer of goods to the Acquiring Company, the detective requested a search warrant of the Acquiring Company's premises

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BATTLING FOR THE PROCEEDS REVISITED: VENDOR MUST DISGORGE PAYMENTS TO DEBTOR'S LENDER (Continued)

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tinued shipments of product resulted in the lender being paid. The bankruptcy court and the appellate court rejected the vendor's arguments, and ordered the vendor to disgorge the $1 million in payments over to the lender.

Vendor's Conversion of Lender's Collateral

The debtor continued to pay the vendor on its delinquent account out of the debtor's accounts receivable even though the receivables were secured and perfected by the lender. The vendor argued that it took the payments from the debtor free and clear of the lender's lien as the lender had impliedly consented to the payments. The court disagreed, and the vendor was unable to produce evidence that the lender consented to the transactions. The vendor was aware that the debtor was instructed by the lender not to use the cash generated from the accounts receivable. The vendor was aware that the debtor had moved its bank accounts to avoid the lender foreclosing on the cash.

No Unjust Enrichment

The vendor argued that the lender was unjustly enriched because the vendor supplied product which allowed the debtor to remain in business even though the product became collateral of the lender and the vendor did not receive payment for the product. Rather, the lender directly benefitted by the vendor's continued shipments, as the debtor continued to operate and repay the lender's loan.

Courts, however, are reluctant to give much weight to a vendor's unjust enrichment argument, as it circumvents Article 9 of the Uniform Commercial Code provisions and the steps a creditor had taken to protect its loan or sale.

Notwithstanding that a lender generally is immune from a vendor's claim of unjust enrichment where it complies with Article 9's provisions, a vendor may prevail on an unjust enrichment claim where a lender defrauds a vendor by encouraging shipments to the debtor, only to have the lender foreclose on the collateral and retain the proceeds.

The court found that there was no evidence that the lender had defrauded the vendor, nor even encouraged the vendor to provide the debtor product. Absent a showing fraud, the court refused to replace UCC priorities with equitable rule of unjust enrichment. The court noted that the vendor could have protected itself from these loses by taking a purchase money security interest in the goods or selling cash in advance.

Lien Priority: No Purchase Money Security Interest for Vendor

The vendor argued that it had not converted the lender's collateral as it had a properly perfected security interest in the cash. The first battle for a vendor embroiled in a priority dispute in the same collateral is establishing compliance with the UCC. Article 9 of the UCC governs perfection of and priorities among conflicting security interests in the same personal property (property other than real estate, with certain exceptions). To obtain a valid PMSI in merchandise they sell, vendors must comply with a multi-step process. The court disagreed finding three areas where the vendor's documentation was insufficient.

Security Agreement Not Descriptive

Article 9 of the Uniform Commercial Code provides a creditor with the steps to create and perfect a security interest in certain collateral. A debtor first executes a security agreement describing the goods covered in favor of the vendor, which gives the vendor a security interest in those goods. Second, the vendor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the goods. Here, the lender complained that the security agreement that described the goods was defective. The court agreed

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PLAYING "CATCH UP" WITH A PREPETITION CLAIM CAN BE COSTLY FOR VENDOR (Continued)

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to the vendor. The trustee alleged that the debtor and the vendor entered into a fraudulent scheme to pay down the vendor's prepetition debt. The trustee contended that the debtor agreed to pay inflated invoices submitted by the vendor for postpetition services to "catch up" and reduce its prepetition claim. The trustee's accountant reviewed postpetition invoices, and compared the prices the debtor paid to the vendor prepetition and postpetition for the same processing services. The trustee's accountant determined that the vendor allegedly overcharged the debtor on average by 68% for postpetition services.

The Equality of Payment Rule for Unsecured Creditors in Bankruptcy

A central principle with the Bankruptcy Code is equality of treatment of similarly situated creditors. The equality of treatment can be seen with the preference laws and plan of reorganization issues. Vendors of the same priority are generally not entitled to be paid on their prepetition claims in Chapter 11 except through a plan of reorganization, and vendors are to each be paid the same pro-rata amount.

In Chapter 11, as a general rule, unsecured creditors may only receive payment on their prepetition claim from the debtor through a confirmed plan of reorganization. The Bankruptcy Code provides that a debtor using postpetition funds to pay a vendor's prepetition claim without bankruptcy court authorization may be recovered, as the payment is an impermissible postpetition transfer.

The Trustee Sues the Vendor to Recapture Overpayments and Aiding and Abetting

The trustee not only sued the vendor to recapture postpetition overcharges to the vendor, but also sued the vendor's vice-president seeking to hold the officer liable for the bankruptcy estate's losses under a theory of a fraudulent scheme to over

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THE SUPREME COURT DECISION OF BANK OF AMERICA V. 203 NORTH LASALLE PARTNERSHIP (Continued)

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Prior to confirmation of a plan of reorganization, a debtor or plan proponent must first obtain approval from the court on its disclosure statement. A disclosure statement is similar to a prospectus in a securities offering. The purpose of the disclosure statement is to provide adequate information to impaired creditors as to their treatment under the plan of reorganization, so that they may be fully informed when they cast their votes.

C. The Plan

The Plan is a re-writing by the Plan proponent of pre-bankruptcy obligations of the debtor. While creditors can agree to a Plan that provides for virtually any kind of treatment, there are certain mandatory statutory requirements for a Plan to be confirmed: (1) it must be demonstrated that members of each class of impaired claims receive at least as much as they would in a Chapter 7 liquidation; (2) it must be proposed in good faith; (3) it must comply with disclosure requirements; (4) it must be feasible; (5) it may not impermissibly classify claims; and (6) non-accepting classes of creditors are entitled to protection under the fair and equitable rule.

While Plans may be proposed of almost limitless variety, so long as the mandatory statutory requirements are met, the more common types of Plans affecting vendors are "extension" Plans, "pot" Plans and "stock for debt" Plans. The "extension" Plan provides for the extension of time to repay debts. This is commonly found where the debtor has a mismatch of assets and liabilities. The debtor commonly has sufficient assets to pay its creditors in full but lacks the cash necessary to pay those debts when they become due. An extension Plan simply provides for repayment of the creditors' claims over an extended period of time. A "pot" Plan concerns the creation of a fund of assets from which the creditors are paid. In "stock for debt" Plans, unsecured creditors are given stock in exchange for cancellation of their unsecured claims.

1. The Plan Voting Process

Each creditor in a class that is impaired is entitled to cast one vote in favor of or against the Plan. The Plan must state whether the creditor class is impaired or unimpaired. A creditor class is impaired if the Plan alters its legal rights (e.g., creditors within the class will not be paid according to the terms of their respective agreements with the debtor). A debtor must receive approval from the majority in number and two-thirds in dollar amount of those creditors voting in that class. Those parties in an accepting class that dissent are protected by what is called the "best interests of creditors test" which requires that the dissenting creditors receive as much under the Chapter 11 Plan as they would in a Chapter 7 liquidation.

2. Cramdown and Unsecured Creditors

Confirming a Plan over a dissenting class is commonly referred to as "cramdown." Courts focus on whether a debtor's cramdown Plan is fair and equitable to the dissenting class of unsecured creditors. A cramdown Plan may be confirmed and may meet the fair and equitable test in one of two situations.

i. Present Value Analysis

First, a cramdown Plan is fair and equitable if the unsecured creditor class receives property with a present value equal to the full amount of its claims as of the effective date of the Plan. Present value analysis is employed where a Plan dictates payment on claims over time. The rationale supporting present value analysis is that a dollar received today is more valuable than a dollar received six months from today as a dollar received today can be invested and earn interest.

Where a Plan provides for a creditor class to be paid over time, the claims are discounted to present value to determine whether the deferred payments actually result in full payments to the creditor class. The discount rate is determined by courts who use the interest rate a debtor would pay as a borrower of a like amount on like terms in the commercial loan market as a benchmark.

ii. Absolute Priority Rule

Second, a cramdown Plan is fair and equitable if no junior creditor class or shareholder class retains or receives anything where a senior creditor class rejects the Plan and is not being paid in full, the so-called "absolute priority rule". This means that a shareholder may not retain is shares of stock if unsecured creditors are not paid in full. An exception to the absolute priority rule, is the "new value" contribution.

iii. New Value Contribution

The new value contribution, or exception, provides that shareholders of the debtor may infuse capital into the debtor to retain their interest, without paying unsecured creditors in full. Although there is conflicting case authority, courts generally allow a new value exception when equity investors contribute new capital that (1) is substantial; (2) equaled or exceeded the value of the retained interest in the debtor; and (3) is necessary. The battleground for unsecured creditors in terms of the new value contribution has been what is a substantial contribution.

III. The Changing Playing Field of Dealing with an Insolvent Debtor in Light of the Supreme Court's Ruling

The Supreme Court's ruling is that the absolute priority rule does not appear to bar a debtor's shareholders from providing new capital, the so-called new value exception, to retain their shares of stock in the postbankruptcy debtor. Without the new value exception, a secured creditor could block a debtor's reorganization by vetoing a plan it viewed as not in its interest. A secured creditor's blocking position could allow this secured creditor to foreclose on the debtor's assets and unsecured creditors lose the going concern value of the debtor. However, the Court's ruling does prohibit the debtor's shareholders from having the

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THE SUPREME COURT DECISION OF BANK OF AMERICA V. 203 NORTH LASALLE PARTNERSHIP (Continued)

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exclusive right of retaining control over the reorganized business over the objection of unsecured creditors.

For vendors this means a Chapter 11 debtor must essentially auction its equity interest to the highest bidder. Vendors should benefit from this competition for the equity as they will be rewarded with additional equity, e.g. cash, being put in. The auction feature may also create greater leverage for the official creditors' committee in the Chapter 11 in terms of attracting competing equity investors. Whether this sale of equity feature may essentially create the opportunity for a hostile takeover of a Chapter 11 debtor remains to be seen.

An unintended result of the Supreme Court's ruling is that a debtor may rethink filing Chapter 11, if the debtor's shareholders believe they may lose control of the debtor postbankruptcy through an equity auction. As vendors are well aware, a debtor often proposes a Chapter 11 plan of reorganization that benefits insiders, with little benefit for unsecured creditors.

If a debtor's shareholders believe that filing a Chapter 11 may result in losing control of the business, a possible alternative for the financially distressed debtor may be an out-of-court workout. The Supreme Court's ruling does not affect nonbankruptcy alternatives. A workout does not impose on a debtor's shareholders the sale of equity to the highest bidder.

A BUST-OUT WITH A HAPPY ENDING FOR VENDORS (IN THIS CASE) (Continued)

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The sheriff's department requested the state court to issue a search warrant as they believed there was probable cause that a crime had been committed at the Acquiring Company's warehouse. The court agreed and issued the search warrant. The search warrant led to seizure of the goods on hand at the Acquiring Company's warehouse. At the time of the seizure, preprinted checks with the Distributors names were found in a desk at Acquiring Company's warehouse. Also discovered was that the principal of the Acquiring Company operated under a number of aliases.

The Vendors Take Action, with the Help of the District Attorney

Vendors filed briefs with the state court demanding return of their goods seized by the sheriff's department under the legal theory of reclamation, and also requesting the court to use its equitable powers as to the fraudulent conveyance claims and order return of the goods. The Acquiring Company's principal filed a motion with the court demanding turnover of the inventory, contending that there was no evidence that the goods were fraudulently obtained. The District Attorney filed papers in support of the vendors position that the goods should not be returned to the Acquiring Company, but requested that a receiver be appointed to handle vendors' claims. The court authorized vendors to depose the Acquiring Company's principal and to inventory their goods on hand at the warehouse. The deposition of the Acquiring Company's principal revealed that the Acquiring Company, as well as the Distributors, failed to maintain business records which made it nearly impossible to trace cash payments and reconcile purchases. The evidence collected by vendors indicated that the Acquiring Company was simply looking to dispose of the goods received from the Distributor, and itself abandon its business, as the Acquiring Company never received any other shipments from other suppliers, indicating an intent to cease operations.

The Goods Were Transferred in Violation of the Bulk Sales Law and Fraudulent Conveyance Laws

All of the inventory of the Distributors was transferred to the Acquiring Company, but no notice of bulk sale was filed by any party. The Acquiring Company supposedly purchased the goods outside the ordinary course and at a discount of between 25% to 50%. The court found that the transfer of goods from the Distributors to the Acquiring Company constituted a bulk sale and subject to notice to vendors. As the Acquiring Company failed to comply with the bulk sales notice requirements, the Acquiring Company was responsible for the vendors' obligations.

The court also found that the transactions between the Distributors and the Acquiring Company were not arms length. The court noted that the principal of the Acquiring Company had leased the warehouse several months before and kept it empty and unused until the purchase of the Distributors inventory. The court also noted that the Distributors were the only suppliers of goods to the Acquiring Company during the period leading up to the planned insolvency of the Distributors.

The court found that the transfer of goods from the Distributors to the Acquiring Company constituted a fraudulent transfer as the Distributors did not reasonably equivalent value for the transfer of goods, and that the Acquiring Company did not qualify as a good faith purchaser.

Vendors May Recover Their Goods Held by the Sheriff

The court found that vendors had superior rights as to the Acquiring Company to the goods. The court ordered that each vendor provide an Order for Reclamation of Goods, supporting the request with invoices for goods shipped. Vendors providing this information were authorized to pick up their goods.

A Vendor's Due Diligence

As this recent case demonstrates, due

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THE BANKRUPTCY REFORM ACT OF 1999: WHAT IT MAY MEAN FOR VENDORS (Continued)

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trustee for under $5,000 has a special set of problems for a vendor. To employ counsel and defend the preference lawsuit usually is not cost effective, even if the vendor has valid defenses. Preference suits in this range appear nothing more than a "shake down" and the beneficiaries of these preference actions often appear to be the trustee and his counsel. The 1999 Bankruptcy Legislation proposes that $5,000 is the minimum preference action that may be pursued. This change should protect smaller vendors most prone to abusive litigation tactics, and the threshold amount does not undermine the policy supporting the preference laws.

4. Venue Change: Suing The Vendor Where It Has Its Principal Place Of Business

For a vendor whose company is based, say, in California and sells goods nationally, being sued, for $5,000 by a bankruptcy trustee where the case is pending, say in Delaware, is extremely inconvenient, thus making it more costly to defend. The 1999 Bankruptcy Legislation proposes that the preferences law should be amended to require that a preference action seeking less than $10,000 must be brought in the bankruptcy court where the vendor has its principal place of business. This change will protect vendors from a trustee taking advantage that it will cost the vendor more to litigate the action than the preference action itself seeks to recover. This change of forcing the trustee to litigate in the vendor's "home court" for amounts between $5,000 to $10,000, will require the trustee to focus on a vendor's defenses, such as the new value and ordinary course of business, thereby reducing abusive preference lawsuits.

5. Amending The Ordinary Course Of Business Exception

Congress has carved out seven exceptions or defenses to the preference laws, where the "preferred" transactions replace value to the bankruptcy estate previously transferred. The most commonly asserted defense to a preference action by vendors is the "ordinary course of business" defense. To qualify for the "ordinary course of business" defense, a vendor must establish that the payment is ordinary as between the parties and that the payment is ordinary in relation to prevailing business standards. The court determines a debtor's ordinariness of payments through comparison with prevailing business standards, which includes common terms used by other trade creditors in the same industry facing similar problems. Thus, only transactions between the parties so unusual as to fall outside the broad range of industry practice should be considered non-ordinary under this preference defense.

The policy supporting the ordinary course of business defense is two-fold: (1) protect customary transactions, and (2) encourage creditors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy.

The 1999 Bankruptcy Legislation rewrites the "ordinary course of business" exception to provide that the conduct between the parties alone should prevail to the extent that there was enough prepetition conduct to establish a course of dealing. If there is not enough prepetition conduct to establish a course of dealing, the industry standard should control.

B. Extending the Reclamation Period

1. What is Reclamation?

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor was defrauded. Under the common law and the old Uniform Sales Act, the seller could only exercise its reclamation rights if it proved the buyer obtained delivery by misrepresenting its solvency. However, the Uniform Commercial Code (UCC), section 2-702, has expanded this remedy where the buyer does not misrepresent solvency. The Bankruptcy Code, section 546, adopts the UCC, but is modified. The Bankruptcy Code requires (1) that the seller's demand for reclamation be made in writing; and (2) in certain circumstances extends the notice period from ten to twenty days. The Bankruptcy Code also provides the bankruptcy court with the ability to grant a seller a lien or priority claim in lieu of the goods. This allows the court to orderr that the goods remain with the debtor to help reorganize.

The UCC not only provides the seller with the right of reclamation, but with a stoppage in transit remedy. Whether the vendor asserts a right to stop in transit or a right to reclaim the goods, the effect is the same that of rescinding the sale by the vendor.

2. 45 Day Reclamation Period

1999 Bankruptcy Legislation will extend the period of time in which a reclamation claim could be raised up to 45 days in certain instances.

C. A Faster Track for Small Business Bankruptcies

Under the Bankruptcy Reform Act of 1994, Congress established a fast track for small business reorganizations for the purpose of making a reorganization less complex and less expensive in chapter 11. These provisions provide that a debtor must elect to be considered a small business debtor. A small business is defined as one whose aggregate, noncontingent liquidated, secured and unsecured debts are less than $2 million as of the date of the bankruptcy filing. The plan confirmation process is expedited for small businesses. The small business exception also may affect how unsecured creditors may protect their interests. The 1999 Bankruptcy Legislation provides that a small business is defined as a company with $5 million or less in secured and unsecured debts. The hearing on the disclosure statement and confirmation of a plan can be combined. Only the debtor can file a plan within the first 90 days. The debtor has a maximum of 150 days from the petition date to have the plan confirmed.

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THE BANKRUPTCY REFORM ACT OF 1999: WHAT IT MAY MEAN FOR VENDORS (Continued)

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Failure to confirm within 150 days will generally result in conversion to Chapter 7.

D. Reviewing an Individual Debtor's Ability to Pay: The "Means Test"

The 1999 Bankruptcy Legislation would make it more difficult for individuals to file for Chapter 7 by imposing a means test -- whether a debtor has any income available to pay creditors. Under the legislation, families with annual earnings of more than the median income (which is currently about $51,000) generally could not file for Chapter 7 protection if they are deemed able to repay 20% of their debt within five years. Instead, a Chapter 13 repayment plan would be crafted for the debtor. A senate version has a less stringent test that gives bankruptcy judges greater discretion in moving debtors out of Chapter 7.

The means test is relevant to the vendor with a delinquent account against a sole proprietorship, as well as the vendor pursuing a personal guarantee.

BATTLING FOR THE PROCEEDS REVISITED: VENDOR MUST DISGORGE PAYMENTS TO DEBTOR'S LENDER (Continued)

(continued from page 5)

noting that:

"The security agreements executed between Debtor and [vendor] include spaces in which to identify the Debtor, the name of the secured party and a description of the collateral. These boxes, however are blank. Because [vendor] failed to execute a security agreement containing a description of the collateral that complied with . . . law, [vendor] does not have an enforceable security interest."

No PMSI with Preexisting Debt

The lender further argued that even if the vendor had a security interest in the goods, it was not a PMSI as it secured preexisting debt. With a PMSI, the vendor takes a security interest only in the goods being sold to secure the purchase price. A PMSI cannot exceed the price of what is purchased in the transaction. Here, the vendor attempted to secure the delinquent account. The court noted:

"[The vendor] placed Debtor on a C.O.D. basis at the same time it filed its financing statements and required Debtor pay for raw materials in full immediately after accepting them. Therefore, there was no doubt to secure with the purchase money security interest other than the antecedent debt."

No Notice to Lender of PMSI

As in the case here, a vendor must take special steps if it is claiming a PMSI in merchandise that will become inventory of the debtor and there is a preexisting inventory secured creditor. A vendor's PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the debtor receives possession of the merchandise (there is no 10 day grace period for perfection as there is with other types of collateral); and (2) the vendor gives written notice to any other preexisting inventory secured creditor. Here, the vendor could not produce evidence that it had given notice to the lender prior to shipping the goods.

Protecting Your Credit Sales

In light of the principle that courts will generally not disrupt a lender's foreclosure of a debtor's collateral in absence of the factors like those discussed above, how does a vendor protect itself while supplying a debtor whose lender holds a floating lien? The simplest method to avoid a third party's foreclosure on your collateral is to sell COD or CIA.

An alternative is to investigate the debtor through the appropriate governmental office (usually the Secretary of State or County Recorder's Office) to determine if a lender has already granted a security interest that poses a threat to repayment. In addition, consider taking a purchase money security interest in the goods. One could also consider approaching the lender to request a subordination of the value of your merchandise to the lender's lien.

1. 217 B.R. 803 (Bankr. W.D. Mo. 1997); also, Commerce Bank v. Tifton Aluminum Company, Inc., 217 B.R. 803 (Bankr. W.D. Mo. 1997).

A BUST-OUT WITH A HAPPY ENDING FOR VENDORS (IN THIS CASE) (Continued)

(continued from page 7)

diligence is crucial for credit executives to avoid a bust-out, and, if ensnared, to promptly investigate and work with local law enforcement.
Common red flags indicating a bust-off may be in the works 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, including: 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; demand a personal guarantee; and discuss the account with other vendors in the industry group.

The vendors diligence, coupled with prompt and persistence efforts by law enforcement and NACM, resulted in a happy ending for vendors -- recovering their goods.

REVISE PREFERENCES (Continued)

(continued from page 2)

By the time the problem is realized by the creditor, the debtor is usually paying beyond the ordinary course of business (with the result being that the creditor has already lost that preference defense).

With money in short supply, the debtor may be not be able to exchange payment for product, nor pay on a cash in advance basis. The creditor is placed in the difficult position of continuing to ship, thereby increasing the credit exposure (and risk of loss) -- or stop shipments, possibly causing the debtor to fail!

Frequently, it is a no win situation!

In the event that the debtor fails, the creditor may find itself being asked to repay funds back into the estate. Alternatively, the creditor must consider spending additional funds trying to defend itself against the preference action -- with little ability to estimate the cost of the defense nor chance of success. And, insult upon injury, the burden of proof is on the creditor!

Clearly this is an unlevel playing field! Creditors should not be penalized for trying to help the debtor survive. Perhaps the best way to do so would be to eliminate as preferences any payments to unsecured creditors (except with insiders or evidence of fraud).

For these reasons, I recommend to Congress revise the preference rules as they now exist.

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PLAYING "CATCH UP" WITH A PREPETITION CLAIM CAN BE COSTLY FOR VENDOR (Continued)

(continued from page 5)

charge the debtor and aiding and abetting the debtor's breach of fiduciary duties.

The Vendor Must Disgorge Overcharges

The bankruptcy court ordered the vendor to disgorge all postpetition overcharges, which totaled approximately $140,000. The court reviewed correspondence between the debtor and the vendor, and considered testimony, and determined that the debtor overpaid for postpetition services to reduce the vendor's prepetition debt. The trustee established that the overcharges were made on account of a prepetition debt and were unauthorized.

The court considered whether the vendor's vice president had aided and abetted a breach of fiduciary. A Chapter 11 debtor owes a fiduciary duty to creditors, which includes maximizing the value of the bankruptcy estate. The debtor in possession, through its management, violate the fiduciary duty when they knowingly pay inflated invoices. The trustee, however, failed to establish that the vendor's vice-president actually knew the debtor was in bankruptcy at the time the debtor paid the inflated invoices, a necessary element to establish a breach of fiduciary claim. The court reasoned that if the vendor's vice-president did not know of the bankruptcy and did not know they were fiduciaries and, thus, violated the Bankruptcy Code. Accordingly, the trustee's claims against the vendor's vice-president for breach of fiduciary were dismissed.

Catch Up Payments Pose Substantial Risk to Vendors

The bankruptcy court's holding should not deter vendors from selling to a Chapter 11 debtor. A vendor's price for product or service may fluctuate after a debtor's bankruptcy filing. If a vendor's postpetition prices are significantly greater than prepetition prices, the vendor should be able to explain the price difference. The court's opinion is a reminder that a vendor's overcharges may be investigated and pursued, whether by a bankruptcy trustee, if one is appointed, a creditors' committee or a creditor. Moreover, a Chapter 11 debtor discloses all payments to creditors through monthly filing of Interim Statements and Operating Reports with the Office of the United States Trustee. The court reminds credit executives attempting to play "catch up" that overcharges through inflated invoices will be disgorged. Moreover, such overcharges may be a bankruptcy crime.