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# THE TRADE VENDOR QUARTERLY

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

## *CRITICAL VENDORS AND KMART: IS THE CRITICAL VENDOR DOCTRINE ALIVE?*

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Credit professionals whose companies have key supplier relationships may find themselves with sizeable unsecured claims should that customer file Chapter 11. However, a number of bankruptcy courts have embraced the critical or essential vendor doctrine. Under the essential vendor doctrine, a vendor may find that the product or service it provides a Chapter 11 debtor is essential to continued operations. The uniqueness of the product or service may give the vendor leverage in negotiating post-bankruptcy sales. More and more bankruptcy courts are considering a debtor's request to treat certain vendors as essential and have their pre-bankruptcy claims paid in exchange for postpetition trade credit.

Kmart's Chapter 11 was one of the largest filings by a retailer. In an effort to obtain unsecured credit from its vendors and maintain key vendor relationships, Kmart, in the opening days of the bankruptcy, rewarded certain key domestic and foreign vendors with payment on their prebankruptcy claims under the critical vendor doctrine. Vendors supplying a range of products from food to music to publishing services were paid on their prepetition claims in exchange for these vendors providing postpetition trade credit. The bankruptcy court authorized payments to the critical vendors totaling $327 million under the "doctrine of necessity" using its equitable powers of section 105 of the Bankruptcy Code. Capital Factors (CF), a company that had factored accounts and held an unsecured claim, objected.

CF appealed the bankruptcy court's ruling authorizing payment to vendors under the critical vendor doctrine. The District Court recently reversed the bankruptcy court.

The main issue on appeal was whether the "doctrine of necessity" provides the bankruptcy court with statutory or equitable authority to allow payment of prepetition unsecured trade claims prior to confirmation of a Chapter 11 plan. The second issue was whether there was a sufficient evidentiary basis for the Bankruptcy Court's ruling.

Under section 105, the "doctrine of necessity", a bankruptcy court's power has evolved to justify the pre-plan payment of prepetition claims of vendors who threaten to withhold goods or services which are critical to the debtor's continued viability and reorganization. This doctrine relies only upon a bankruptcy court's equitable powers.

The district court agreed with CF that pursuant to the Bankruptcy Code, a court cannot ignore the statutory scheme of priority and express treatment of unsecured claims as provided in the Bankruptcy Code in favor of "equity." Although the payments to vendors are useful and practical, they are not authorized by the Bankruptcy Code the district court stated. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment

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## *PREFERENCE RELIEF: BANKRUPTCY COURT TAKES HARSH STANCE AGAINST TRUSTEE FOR DUPLICATIVE ACTION AGAINST VENDOR*

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Does a debtor get two bites at the proverbial apple, first, by objecting to your claim and then, second, by filing a preference action against you? No, not if the case is litigated before Judge Lloyd King in the District of Delaware.

As a credit professional, you receive notice that one of your customers has filed for bankruptcy. The debtor schedules your company's claim for less than the balance owed, and you timely file your proof of claim. Thereafter, the debtor objects to your proof of claim, but you resolve the objection and the bankruptcy court approves your settlement. Now, all you have to do now is wait for your distribution check, right? That is what creditor TKA Fabco Corp. ("TKA") thought before it was served with a preference complaint by the liquidating trustee in *In re Cambridge Industries Holdings, Inc.*

In corporate bankruptcy filings, debtors often resolve claim objections before seeking bankruptcy court confirmation of a plan of reorganization. Once a plan is confirmed, debtors are often succeeded by liquidating committees, disbursing agents or other entities that are assigned avoidance powers by the debtor and are required to make distributions under the plan. These entities often pick through any "assets" of

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## *IS YOUR CUSTOMER PROPOSING AN OUT OF COURT WORKOUT INSTEAD OF BANKRUPTCY PROTECTION: WHEN SHOULD A CREDITOR SWEAT WITH A DEBTOR*

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The story of a debtor's financial struggles is all too common in today's economy. It begins by the debtor describing that its industry is mired in the trough of a cyclical slowdown … that the slowdown reduced customer demand and created overcapacity in the industry, and more particularly, in the debtor's operations … and that as a result, the debtor experienced operating losses and cash flow difficulties. The debtor then rides this slippery slope of obscurity into an enthusiastic picture of an anticipated turnaround to the profitable days of yesteryear. However, as credit extensions become increasingly rare, and collection actions more familiar, the debtor finally concludes that reorganization is the only avenue to remain in the marketplace. Instead of electing business reorganization under chapter 11 of the Bankruptcy Code or an assignment for the benefit of creditors, the debtor sends you a "confidential communication" requesting your presence at a meeting of its creditors to discuss an out-of-court workout. Should the credit professional be receptive to this request or solicit others to force an involuntary bankruptcy? It all depends on the chances for recovery.

**Workout Agreements**

A financially struggling debtor may propose an out-of-court workout to its creditors to avoid formal relief under chapter 11 of the Bankruptcy Code. An out-of-court workout is a contractual agreement made between the debtor and its creditors to resolve outstanding debt obligations, and at the same time, direct a course toward financial stability. A credit professional should balance the advantages of a workout agreement against the advantages of reorganization through bankruptcy.

A workout agreement enables a debtor to address its primary concern of burdensome debt without the stigma that a bankruptcy filing may entail. Through a workout, the debtor avoids the public scrutiny of a bankruptcy case, shields its customers from competitors seeking to cash in on the debtor's demise, and manages internal relations with employees in a much less intimidating manner. The positive atmosphere that the workout may accomplish assists all parties in interest by focusing on the issues that led to the debtors' financial difficulties and charting a course to profitability.

More important, a workout is usually expeditious, less expensive, and interferes only minimally with the debtor's operations. Workout agreements are proposed and accepted within a short period of time after the meeting of creditors. In the context of bankruptcy reorganization, a bankruptcy case may take several months, and perhaps years, prior to the acceptance of a plan. Even after a plan is accepted, payment of prepetition obligations is further delayed thorough post-confirmation litigation of preference actions and other avoidable transactions. The delay of bankruptcy reorganization also has a collateral effect on the expenses to the debtor's estate. In bankruptcy, the debtors are required to pay for the services and costs of professionals through administrative expense claims. As an administrative claim, the professionals are paid prior to the other creditors, which will affect the amount of a distribution

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*FROM THE PUBLISHER:*

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Guest Column

## *PUBLIC WORKS CONSTRUCTION REMEDIES*

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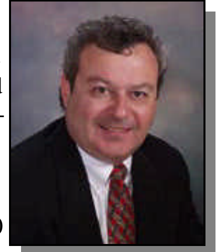

Construction projects are often awarded to the lowest bidder. However, that can increase the risk of default because the successful bidder is often the one with the lowest overhead -- and usually few if any unencumbered assets.

The Miller Act of 1935 [ 40 U.S.C. 270 (a) – (f)] requires performance and payment bonds for federal public works projects:

(a) the performance bond insures the government for the successful completion of the project.

(b) the payment bond insures subcon tractors ("SC") that they will be paid by the general contractor ("GC").

(c) sometimes the process starts at the bidding stage with a bid bond. This demonstrates that the contractor is bondable, and provides some protection to the government by providing a third party guaranty that the contractor will start the project.

A typical bid bond might be 20% - 40% of the contractor's bid -- which is forfeited in the event that the contractor fails to start work; or fails to provide the required performance and payment bonds within the prescribed time limit.

The states have enacted similar statutes often referred to as "The Little Miller Acts."

**In the event that a job is bonded and the GC defaults, the surety essentially has four options:**

1. put out the uncompleted work for bid by other contractors
2. finance the original GC to complete the job
3. the surety could do the work itself (an impractical option)
4. pay the bond penalty (often

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## *REDUCING THE RISK OF THE ERRANT E-MAIL WITH NEW TECHNOLOGY: DISAPPEARING E-MAIL*

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E-mail is revolutionizing how credit professionals communicate. As the credit department goes electronic, credit professionals depend even more on e-mail to communicate with customers and credit colleagues. Credit professionals are also using e-mail to automatically invoice customers through their Web site, and customers are providing credit professionals with confidential financial information to assist with the credit analysis. The credit professional and customer can negotiate online over credit terms. Underscoring the explosion of e-mail use in B2B, businesses around the world sending 13 billion e-mails a day.

However, the speed and ease of e-mail has resulted in a less formal means of communicating than letters. The ability to share electronically confidential customer information carries with it some risks to the credit professional. Further, an errant e-mail, or one that is carelessly written, can prove costly to a vendor that may later be involved in litigation with a customer. Indeed, it seems daily there is a headline of an errant or poorly worded e-mail harming a business.

What e-mail protocol should the credit department follow to reduce the risk of an errant e-mail? Where a credit professional has been provided a customer's confidential information through e-mail, what steps should the credit professional take to keep e-mail communication confidential and out of a lawsuit?

**E-Mail and Protocol**

E-mail tends to be more relaxed, containing discussions that would not normally be committee to paper. Every employee in the credit department should regard e-mail as formal as a written letter. Communications regarding customers should be kept "G-rated" in order to avoid exaggerations being taken out of context. Unlike a phone conversation that is temporary and not recorded, the e-mail, as discussed below, may not be. An e-mail can be the "smoking gun" in a customer dispute or government audit. Moreover, the e-mail can be used to assist in the testimony of the author of the e-mail, compared where the conversation was by phone and the party has forgotten.

**E-Mail and Confidentiality**

On occasion, a credit professional will receive financial information from a customer where the credit professional must sign a confidentiality agreement and agree to keep the information confidential. The credit professional must take reasonable steps to maintain the secrecy of the documents. The standard confidentiality agreement provides that the credit professional's company may be liable for damages if the confidential information is leaked.

**E-Mail and Litigation**

In litigation with a customer, the customer may want information from the vendor to build its to support for non-payment. The customer may send a subpoena requesting e-mail and other electronic communications from the vendor. With electronic discovery, e-mails involving the customer may be ordered produced.

A problem with e-mail from a litigation standpoint is that it creates a lasting record, unlike a phone call that is temporary. A vendor can be compelled to produce e-mailed material in litigation, unless otherwise privileged. If the credit professional's company has a uniform policy of e-mail expirations or shredding its e-mail unless it has some future value, the company embroiled in litigation will likely not be punished by a court if it does not turnover the information. However, if the vendor is embroiled in litigation it may make sense to retain the e-mail to avoid a negative suggestion.

**New Technological Developments for Keeping E-Mail Communications Confidential and Out of a Lawsuit**

Recent technological developments may provide greater protection for the credit professional from an errant or confidential e-mail falling in the hands of a competitor or other unintended party. New e-mail systems can tell messages to self-destruct after a certain amount of time, can limit the number of times a message is opened and read, tag messages so that they cannot be forwarded and label messages to prevent cutting, pasting or printing. This means that such e-mails are temporary, and from an evidentiary basis, may not fall in the hands of a competitor or used in a law-

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## *REPLACEMENT CHECKS AND THE BANKRUPTCY PREFERENCE: DO YOU KEEP THE MONEY?*

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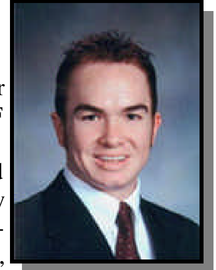

The good news is your customer replaced its NSF check to you. The bad news is the customer filed bankruptcy within ninety days of issuing the replacement check. Consequently, the trustee demands return of the value of the replacement check as a preference. What are your preference defenses when you have received a replacement check?

A replacement check intended to substitute a NSF check which is initially transferred contemporaneously for new value may not be protected from the trustee's avoidance powers. Bankruptcy courts have interpreted 11 U.S.C. § 547(c)(1) to stand for the proposition that a replacement check is not a contemporaneous transaction, and generally is not tendered for new value, thus empowering the trustee to avoid the transfer.

In *In re JWJ Contracting Company, Inc.*, 287 B.R. 501 (9th Cir. 2002), the court held that the substitution of a Cashier's Check (i.e., replacement check) was not a contemporaneous exchange for new value. The court found that the replacement check constituted a credit transaction, not a cash transaction, thus the new value exception would not protect a replacement check payment made to the vendor within the preference period.

In *JWJ*, the debtor issued a check to the vendor in exchange for an unconditional lien release that waived the vendor's right to payment under a city bond. The debtor's bank returned the check to the vendor unpaid for insufficient funds. Within two weeks the debtor replaced the NSF check with a cashier's check. Although the vendor asserted that they gave a contemporaneous exchange of new value for the payment when they released their lien, the trustee asserted that the later accepted "replacement check" cannot constitute a contemporaneous exchange for new value.

In order to analyze why the replace-

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## *DOCUMENTING YOUR CREDIT SALE IN CYBERSPACE: TRADITIONAL CONTRACT PRINCIPLES APPLY*

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The credit department is going electronic. Following these electronic advances, your company posts the credit application on its web site. Your customer completes the credit application electronically and e-mails the completed application to you. Is your customer bound by the terms and conditions of your credit application, such as default interest, attorney's fees and venue selection, should you end up in a dispute? Does an electronic or digital signature (e-signature) have the same legal effect as a handwritten signature from your customer on your credit application? Are there other legal areas of concern for the credit professional with the e-credit application and documenting the credit sale electronically? In *Specht v Netscape Communications Corp.,* the court recently considered whether a digital signature bound the customer to the electronic contract.

**What are Electronic, or Digital, Signatures?**

E-signatures are a form of technology, including fingerprint readers, stylus pads and encrypted "smart cards", used to verify a party's identity so as to certify contracts that are agreed to over the Internet. This means that a credit professional documenting a commercial e-sale has many technological methods to verify a customer's representatives' signature.

**State and Federal Legislation**

Article 2 of the Uniform Commercial Code provides that with the sale of goods over $500, there must be a signed writing. A signature is to certify the writing for the sale of goods. With the traditional sale of goods over $500, the credit professional would memorialize the sale agreement with a signed credit application and signed invoices.

**An E-Contract?**

In *Specht v Netscape Communications Corp., 2002*, the court considered whether an electronic signature may bind the customer to contract terms posted on the company's website. In *Specht,* the plaintiffs downloaded a software program from defendant's web page. According to the plaintiffs, they did not agree to certain terms on the web page, such as an arbitration provision.

The plaintiffs argued that they were unaware that activating a download icon on defendant's website and signifying assent to acquire the software clandestinely enabled the defendants to distribute the plaintiffs' personal file names to makers of a separate "plug-in" software program. The plantiff's alleged that this second program on defendant's website violated certain federal statutes.

The plaintiffs said that they agreed to subscribe to the software program but that the webpage did not disclose that a potential user of a second software program must scroll down and strike a computer key affirmatively agreeing to the terms of the contract containing the license provision and its arbitration clause.

**Binding the Customer: Electronic Signatures**

The Electronic Signatures in Global and National Commerce Act (The E-Sign Act) makes e-signatures as legally binding as ink-and-paper signatures, and can be used in legal proceedings. An e-signature is generally defined as a form of technology, including fingerprint readers, stylus pads and encrypted "smart cards", used to verify a party's identity so as to certify contracts that are agreed to over the Internet. The E-Sign Act, a federal law, and state law counterparts, validates electronic signatures, but to enforce an e-contract the signatory must "assent" to the terms.

In *Sprecht*, the court observed that a prospective party to an e-contract actions of clicking a keystroke on a computer does not form a contract, should the offer (credit application on the web site, for example) does not clearly signify that such an act constitutes consent. Because the parties had signed the original software contract and were bound by its licensing agreement containing the arbitration clause, the court had to determine whether its terms were broad enough to include coverage of a second and related agreement (the second software agreement).

In *Specht*, the plaintiffs did not see the licensing agreement for the second software program, despite subscribing to the initial advertised program, without instruction to "scroll down" to the next page on the Web site. No contract was formed, said the court, without the vendor informing the party of this additional act necessary to form the contract.

**E-Signatures: What it may mean for the credit professional**

As the credit department goes electronic, the *Sprecht* decision reminds the vendor that its e-documents, from credit applications, to order acknowledgments and invoices, should plainly set out any provisions that the vendor seeks to bind the customer. For example, the below may be considered as the kind of plain language:

By selecting we accept, I am attaching my electronic signature to, and our business agrees to, the [vendor's] terms and conditions contained in the above credit application. Futhermore, I am authorized to sign the credit application on behalf of our business.

0 Accept
0 Do not accept

Transacting commercial credit sales via the internet means lower transaction costs for the vendor. However, a credit professional must be sure that the customer is agreeing to the terms of sale

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## CRITICAL VENDORS AND KMART

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of prepetition unsecured claims, the court observed. The district court found that the bankruptcy court did not have either the statutory or equitable power to provide such relief.

Kmart argued that CF's request was moot because the critical vendor payments had been made, and that the vendors who received the payments relied upon such payments extended postpetition credit. The district court ruled that it is not too late to order that the monies paid be returned, because there has not been a confirmation of a bankruptcy plan.

Thus, the district court reversed the bankruptcy court's order authorizing payment of prepetition claims to certain critical vendors. The district court's ruling is being appealed to the 7th Circuit Court of Appeals. Even so, one of the biggest obstacles to the court's approval of the reorganization plan was removed when CF reached a deal with Kmart. Kmart will pay back some of the debt, and ESL (Kmart's largest shareholder) will buy an unspecified part of the debt. Kmart agreed to try to get back some payments to so-called "critical vendors" it made at the outset of its bankruptcy case. CF will get 15% of the money Kmart recovers from the "critical vendors," up to $2 million.

The district court's ruling out of the Northern District of Illinois does not bind bankruptcy courts in jurisdictions such as Delaware, New York and Los Angeles, for example. Thus a debtor may request the bankruptcy court approve critical vendor payments. For the vendor, be mindful that should a party appeal a bankruptcy court's authorization to make critical vendor payments, those payments may be subject to disgorgement. The district court's ruling may be significant for courts bound by the decision, as even if a debtor may establish that its business will be jeopardized if a vendor that is critical will not ship if not immediately paid under the critical vendor doctrine, a bankruptcy court may not grant such request. Vendors will keenly watch whether bankruptcy courts around the country follow or reject the district court's reasoning in Kmart. At a minimum, expect the debtor to be more demanding of vendors in establishing the critical nature of the product or service given the heightened court scrutiny of these requests.

## PUBLIC WORKS CONSTRUCTION REMEDIES: BONDING NOT BONDAGE

*(Continued from page 2)*

100% of the order to the GC) and walk away.

The bankruptcy filing of a GC may not always result in an event of default. Sometimes, the surety with the consent of the court is granted a "super priority lien" in exchange for providing new Debtor in Possession ("DIP") financing.

Many creditors make the mistake of thinking that they are automatically protected whenever there is a payment bond. However, for federal public works projects (such as U.S. Army Corps of Engineers projects) where the amount of the contract exceeds $ 5 million, the statutory minimum for the bond is $ 2.5 million.

The $ 2.5 million is the amount for all claims combined. Thus, in extremely large contracts, the amounts owed or potentially owed to SC can grossly exceed the protection afforded by the payment bond.

In practice, how the surety divides the $ 2.5 million seems to be "less than fixed in granite." Underwriters say that in some cases the surety has paid "first come, first served," and those who came late got nothing. However, that appears to be the exception rather than the rule. To be safe, creditors should notify the surety as soon as serious problems appear.

Often large jobs are bid by several GC's acting as a "joint venture" ("J/V"). What happens in the event of a default of one of the J/V? Each member of the J/V is responsible with 100% of its assets for the financial obligations of the project. In the event that one partner cannot complete its obligations, the other(s) must do so -- as supported by their own surety bond(s).

In other projects, it is common for the bonds to be 100% of the contract values. Obviously those bonds provide greater protection for SC.

With more than one project running simultaneously, the surety often has multiple obligations to a GC. However, bonds for each project are considered unique. Obligations on one project will not "spill over" to any other. From a bonding perspective, any deficit on one project cannot e applied against a surplus on another – and vice verse.

How (and when) should creditors determine whether the project is bonded? In order to avoid problems "down the road," it is extremely important to request this information from your customer prior to order placement.

However, failing this, you may still be "in the ball game." Many statutes (including The Miller Act) require the GC to furnish a copy of the bond upon request. However, be forewarned that there are strict "time windows" in which to make claims, and even a day's delay may render your claim null and void.

The Surety Association of American ("SAA" – the trade group of the surety industry) has established on behalf of participating members, a voluntary Bond Authenticity Program. The author has used this program and his inquiries have always been met with a timely response from the individual surety.

To find out about the program, simply log onto the SAA home page at www. surety.org , then (in the middle side bar) click on the word "Surety."

On extremely large or complicated jobs, it may be in your best interests to assess the financial condition of the surety. The leading rating company is A M Best Company.

Ratings on individual sureties may be obtained by (a) automated telephone/fax reply, or (b) on-line via the A M Best Company's home page at www.ambest.com , then go to the upper left of your screen and click on the top choice, "Ratings & Analysis." Next, in the right hand column, enter the name of the surety in the search field. Finally, the site requires registration which can be accomplished somewhat simultaneously (and, as of press time, was free).

Also, may states have enacted legislation establishing a trust fund whereby the construction funds are deemed to be held in trust by the GC, and not considered property of the GC's estate. However, that is a topic for another time.

Douglas G. Fox, CCE specializing in business bankruptcy seeks telecommuting job out of Philadelphia or Manhattan: foxbern@acninc.net

## *PREFERENCE RELIEF: BANKRUPTCY COURT TAKES HARSH STANCE AGAINST TRUSTEE FOR DUPLICATIVE ACTION AGAINST VENDOR*

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the debtor to see if there are any matters worth pursuing for the benefit of creditors, unsecured and administrative alike. Often, especially in recent years, these postconfirmation entities will file preference actions seeking the recovery of transfers made by the debtor to the creditor within the ninety days preceding the petition date. Some bankruptcy courts, such as the one in bankruptcy case of *In re Cambridge Industries Holdings, Inc.*, may come to the rescue of the creditor and prevent that creditor's claim from being relitigated, if it was previously resolved through a claim objection.

In *In re Cambridge Industries Holdings, Inc.*, TKA timely filed its proof of claim for $173,425.63, to which the Debtors objected. The parties resolved the claim objection and TKA received an allowed claim for $166,672. The settlement was approved by the bankruptcy court, and TKA received its first distribution under the confirmed plan of reorganization. Thereafter, the Liquidating Trustee filed a preference complaint alleging that TKA received avoidable transfers of $91,227.

TKA filed a motion for summary judgment asserting that the Liquidating Trustee was precluded from religating the same claim. The bankruptcy court found that the language of 11 U.S.C. section 502(d) and principles of fairness do not permit sandbagging a creditor by first objecting to and obtaining a stipulated order allowing the claim in a reduced amount and, after the claim objection has been resolved, commencing an adversary proceeding alleging that the creditor received an avoidable preference. The court found that 11 U.S.C. section 502(d) mandates that the resolution of the Debtor's claim also resolves any potential preference claim by the Debtor against TKA.

1. So next time you receive that claim objection in the mail, it may be a blessing in disguise. If you are later the subject of a preference action, you just might find the bankruptcy court at your protection.

## *IS YOUR CUSTOMER PROPOSING AN OUT OF COURT WORKOUT INSTEAD OF BANKRUPTCY PROTECTION: WHEN SHOULD A CREDITOR SWEAT WITH A DEBTOR*

*(Continued from page 2)*

Further, a workout agreement has a minimal affect on the debtors' operations and does not require a court order for use of cash, filing of monthly operating reports, and other operational scrutiny. Instead, a workout permits the debtor to focus on returning its operations to profitability.

**Reorganization and the Bankruptcy Code**

Although the informal context of a workout is a valuable method to achieve payment, the more viable alternative may be a formal reorganization. The Bankruptcy Code provides several statutory protections to assist the debtor through its reorganization efforts, which are unavailable through a workout. One of the more useful protections of the Bankruptcy Code is the automatic stay. The automatic stay imposes a freeze on all suits, foreclosures and similar actions against the debtor's assets, which comprise the debtor's bankruptcy "estate." If the debtor is facing a flood of litigation, then the automatic stay creates breathing space for the debtor to focus its attention on the reorganization of its operations. Another operational advantage to reorganization under the Bankruptcy Code is the debtor's ability to reject executory contracts and unexpired leases. This is especially important if the debtor remains liable for burdensome contracts and unexpired leases, which may be over market or simply no longer a part of its operations.

The Bankruptcy Code also offers unique strategies to achieve a successful reorganization that are not always available through a workout. If management concludes that a sale of the debtor's assets is the only way to effectuate reorganization, then the debtor is entitled to sell its assets free and clear of liens and encumbrances, and oftentimes, without the of secured creditors. This remedy is not available under a workout and may invite protracted litigation by secured parties in an attempt to protect their individual interests. In addition, under certain circumstances, the Bankruptcy Code permits the "cramdown" on dissenting creditors of the provisions of a plan. In the workout setting, creditors may "opt-out" of the workout agreement and seek their own recoveries. Further, reorganization under the Bankruptcy Code permits the recovery of preferential transfers and the avoidance of liens and fraudulent conveyances. Accordingly, reorganization under Bankruptcy Code provides an even playing field for all creditors to recover their proportionate share of available funds whereas a workout may pay certain creditors ahead of others (i.e., judgment lien creditors).

**Meeting of Creditors**

The first step toward a successful workout will require the debtor to convene a "meeting of creditors." The meeting normally consists of general unsecured creditors only. At the meeting of creditors, the debtor is usually prepared to confidentially discuss the issues that created its financial difficulties, its current revenues and debt structure, prior and future efforts to reorganize its operations, and other information to convince creditors that a workout is the best chance for payment.

**Formation of a Creditors' Committee**

The formation of a creditors' committee is also a primary importance at the meeting of creditors. The role of a creditors' committee is similar to that of a chapter 11 creditors' committees. Essentially, the creditors' committee serves as the "watchdog" of the debtor's affairs and makes decisions and recommendations to the debtor's creditors.

The selection of the committee should closely correspond to the requirement of the Bankruptcy Code since a failed workout, or alternatively, a dissenting creditor group seeking an involuntary petition, may land the debtor in bankruptcy. If the debtor is forced into bankruptcy, then the workout committee may continue its functions and relationship with the debtor as a chapter 11 creditors' committee. Generally, a creditors' committee should be fairly chosen after notice is given and consist of a fair representation of the creditor body.

Similar to the bankruptcy context, the creditors' committee should seek legal counsel and other professionals as soon as practicable. It is imperative in the workout process that the creditors' committee receives competent legal advice since the debtor's are subject to less scrutiny than

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## *IS YOUR CUSTOMER PROPOSING AN OUT OF COURT WORKOUT INSTEAD OF BANKRUPTCY PROTECTION: WHEN SHOULD A CREDITOR SWEAT WITH A DEBTOR*

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under the administration of a bankruptcy case. Generally, the debtor will compensate the creditors' committee's legal counsel for its costs and services. The individual committee members are also entitled to compensation for expenses.

**The Workout Agreement**

One of the advantages to a workout plan is the flexibility associated with framing an agreement. The essential components of a workout agreement include the payment plan, moratorium on collection and similar activity, monitoring rights of creditors concerning the debtor's operations, and adequate protection for creditors that the debtor fulfills the conditions of the agreement. The terms and conditions of the workout agreement are the result of extensive negotiation between the debtors and creditors' committee, usually through their respective counsel. In addition, if secured debt is involved, the secured parties may want to be involved in the negotiation of an agreement. In any event, the terms and conditions of the workout should be framed to mirror the terms and conditions of a plan of reorganization in the event that the debtor is forced into bankruptcy.

**Payments under a Workout Agreement**

Generally, there are two types of workout agreements. An "extension" agreement restructures the debtor's obligations for payment in full over a period of time. Alternatively, a "composition" agreement reduces debt obligations and creditors receive only a fraction of their claims. There are also hybrid plans that may pay a fraction of the claim over a period of time or payment may be received in goods or products of the debtor.

**Creditors Subject to the Workout Agreement**

A workout agreement is a contract and only binding on the creditors that accept the agreement. Accordingly, creditors that do not agree with the workout are free to pursue their own agendas. Although unanimity is difficult, if not impossible to reach, the workout agreement should seek the approval of one-half of the creditors holding claims totaling at least two-thirds in value. Granted adequate disclosures are made by the debtor, the terms and conditions of the workout agreement may be incorporated into a plan of reorganization and quickly enforceable if the debtor is forced into bankruptcy.

**Conclusion**

An out of court workout agreement is a valuable method to seek payment from the debtor. The workout may result in a faster plan for payment, reduction in professional fees, and minimal disruption to the debtor's operations. Moreover, it is especially important if creditors' would not receive a distribution in a chapter 11 reorganization since payment may be structured to suit the needs of all parties including the debtor, secured creditors, and general unsecured creditors.

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## *REPLACEMENT CHECKS AND THE BANKRUPTCY PREFERENCE: DO YOU KEEP THE MONEY?*

*(Continued from page 3)*

ment check did not qualify as a contemporaneous exchange for new value, we must analyze the nature of an 11 U.S.C. § 547(c) defense to a preferential transfer. To illustrate, pursuant to § 547(c), the trustee may not avoid a transfer made to a vendor, (1) to the extent that such transfer was -- (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact was a substantially contemporaneous exchange. The contemporaneous exchange for new value defense "is grounded in the principle that the transfer of new value to the debtor will offset the payments, and the debtor's estate will not be depleted to the detriment of other creditors." *Lumbman v. CA Guard Masonry Contractor, Inc. (In re Gem Constr. Corp. of Virg.)*, 262 B.R. 638, 645 (Bankr.E.D.VA.2000). According to § 547(a)(2), "new value" in the context of a contemporaneous exchange means "money or money's worth in goods, services, new credit, or a release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." The problem with a replacement check is that the debtor is substituting it for an existing obligation; ordinarily no new value is transferred to the debtor.

The parties' intent with respect to the transaction is a key factor to consider when analyzing the effect of the replacement check. Note that the party asserting a contemporaneous defense "has the burden of proving that the parties intended the transfer to be a contemporaneous exchange for new value, that the exchange was contemporaneous, and that new value was given." *Dye v. Rivera (In re Marino)*, 193 B.R. 907, 913 (9th Cir. BAP 1996).

As mentioned above, when analyzing the replacement check's effect on a new value defense, one must determine whether the replacement check (i.e. substituted check) was exchanged for new value. A review of the legislative history of § 547(c)(1) reveals that the payment of a debt by means of a check is equivalent to a cash payment unless the check is dishonored. Customarily, when a vendor receives a replacement check, the check satisfies a pre-existing debt and therefore is not a contemporaneous exchange for a new value. Congress also expressed in the legislative history of § 547(c)(1) that a credit transaction cannot be considered contemporaneous.

The court in *JWJ* reasoned that the dishonor of the check changes the nature of the transaction from one intended for a contemporaneous cash exchange to a credit transaction. Essentially, the court found that the creditor "did not [intend to] give new value for the promise to make the dishonored check good. Rather, the creditor intended that the cashier's check would replace the dishonored check." *In re JWJ Contracting Company, Inc.*, 287 B.R. 501, 511 (9th Cir. 2002). Therefore, a replacement check generally will not qualify as a contemporaneous exchange for new value because it is a non-contemporaneous credit transaction with no new value given to the debtor. Moreover, a replacement check is typically issued with the intent to replace a previously dishonored check, thus the bankruptcy court will generally allow the trustee to avoid the transfer. Consequently, vendors must be mindful of their preference defenses when accepting a replacement check which substitutes a check drawn on insufficient funds.

## *REDUCING THE RISK OF THE ERRANT E-MAIL WITH NEW TECHNOLOGY: DISAPPEARING E-MAIL*

*(Continued from page 3)*

suit.

New developments for e-mail may also allow for the credit professional to block the recipient from pasting, printing or forwarding, including the accidental forwarding, the e-mail message. In other words, the credit professional may encrypt a set of rules with its e-mail that blocks forwarding the e-mail -- a virtual e-mail paper shredder. Encryption is used to keep online communications like e-mail private. This would allow that a confidential email communication not fall in the hands of a competitor. The recipient unlocks the e-mail with a key and is bound by the credit professional's terms. Another development is e-mail that is automatically erased after 24 hours after being opened, the equivalent of disappearing ink. Of course, for the credit professional looking to retain a customer's confidential information disappearing e-mail does to work.

The benefits to the credit professional for using encrypted e-mail is that confidential information, be it communications with a customer over credit terms or financial information provided by the customer, will not end up in a lawsuit or open up the door for the credit professional's company from being sued for breaching a confidentiality agreement.

## *DOCUMENTING YOUR CREDIT SALE IN CYBERSPACE: TRADITIONAL CONTRACT PRINCIPLES APPLY*

*(Continued from page 4)*

with the e-contract. With the recent legislation, a credit professional may transact credit sales over the Internet and bind the customer with an e-signature, rather than a handwritten signature, provided the credit application, for example, clearly sets this out. This step will further the use of Internet contracts, as well as guarantees, by credit professionals.

# RECENT ENGAGEMENTS AND ACTIVITIES

***Blakeley & Blakeley LLP Recent Engagements and Activities for Summer 2003***

*Blakeley & Blakeley continues to represent its vendor clients in the areas of creditors' rights, commercial litigation and collection, preference defense, credit documentation, bankruptcy and out-of-court workouts.*

◊ Scott spoke to the ***National Electric Distributors Association*** in Irvine, CA regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to ***NACM's Loss Prevention Group*** in Las Vegas, NV regarding ***Credit Cards.***

◊ Scott spoke to ***NACM/Maryland*** via teleconference regarding ***Article 9.***

◊ Scott spoke to the ***NACM/Connecticut Fine Paper and Newsprint Group*** in Los Angeles, CA regarding ***Creditors' Rights.***

◊ Scott spoke to ***Credit Research Foundation*** in McKinney, TX regarding **E-Credit.**

◊ Scott spoke to **Bay Area Credit Professionals** in Milpitas, CA regarding ***Commercial Law Developments.***

◊ Scott spoke to ***National Group Management*** in Las Vegas, NV regarding ***Hot Topics for 2003.***

◊ Scott spoke to ***Orange County Credit Professionals*** in Irvine, CA regarding ***Escheatment***.

◊ Scott spoke to the ***NACM/Louisville*** in San Diego, CA regarding the Bankruptcy and ***Creditors' Rights***.

◊ Scott spoke to the ***National Food Suppliers Group*** in Las Vegas, NV regarding ***Preference and Bank Developments.***

◊ Scott spoke to ***NACM*** via teleconference regarding ***Critical Trade Vendors.***

◊ Scott spoke to the ***NACM/Chicago National Musical Group*** in Anaheim, CA regarding the ***Creditors' Rights.***

◊ Scott spoke to ***NACM/Tampa*** in Las Vegas, NV regarding ***Financial Reporting and Accounting.***

*Continued on Next Page*

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*Blakeley & Blakeley continues to represent its vendor clients in the areas of creditors' rights, commercial litigation and collection, preference defense, credit documentation, bankruptcy and out-of-court workouts.*

- ◊ Scott spoke to ***NACM/Texas*** in Las Vegas, NV regarding ***Creditors' Rights***.
- ◊ Scott spoke to ***NACM/Oregon*** regarding ***Internet Developments.***
- ◊ Scott spoke at the ***CMAC Annual Meeting*** in Los Angeles, CA regarding ***Sarbanes Oxley and Corporation Fraud***.
- ◊ Scott spoke to ***Dun & Bradstreet*** in Santa Fe, NM regarding ***Bankruptcy***.
- ◊ Scott spoke to ***CMA/Computer Industry Credit Group*** in Irvine, CA regarding *Credit Applications*.
- ◊ Scott spoke to ***NACM/Florida*** in San Jose, CA regarding ***Creditors' Rights***.
- ◊ Scott spoke to ***NACM/Florida*** in San Diego, CA regarding ***Pre-Sale of Goods.***
- ◊ Scott spoke to ***Staffing Services Group*** regarding ***Creditors' Rights.***

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