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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

THE BANKRUPTCY REFORM ACT OF 2005:

WHAT IT MEANS TO THE CREDIT AND FINANCIAL PROFESSIONAL

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After eight years of political wrangling, the U. S. Bankruptcy Code has finally been overhauled, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"). How does the 2005 Act impact the vendor? Does the vendor have greater protections and rights as a result of these amendments? What strategies may a vendor consider to maximize payment on a delinquent account where a customer may consider bankruptcy?

A. 2005 Act Effective Date (Sections 1406 and 1501)

On April 20, 2005, the 2005 Act was enacted and most provisions become effective as to new cases filed 180 days after this date, which is October 17, 2005.

a. What It Means For Vendors

During the 180 days from enactment of the 2005 Act and the legislation taking effect, vendors may experience more sole proprietor customers and personal guarantors filing Chapter 7. Sole proprietors and guarantors may file Chapter 7 prior to the 2005 Act becoming effective so as to have their debts discharged, rather than risk having their Chapter 7 petition converted to Chapter 13 or dismissed. If converted to Chapter 13, the debtor will have to propose a plan to pay off a portion of their debt as a result of a creditor invoking the means test provision contained in the 2005 Act. If the bankruptcy case is dismissed, the debtor will have to deal with the creditor's collection efforts, unimpeded by the automatic stay.

B. Rewriting The Preference Laws

The 2005 Act reforms the preference laws in the following ways.

1. What Is A Preference? (Section 547)

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 purposes 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 there may be an equal distribution of a debtor's assets.

2. Minimum Threshold To Sue For A Preference (Section 410)

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RESTRUCTURING AGREEMENTS AND THE ORDINARY COURSE OF BUSINESS DEFENSE

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If a credit manager finds him or herself in the all too familiar position of having to restructure a debtor's obligation, are payments made pursuant to the restructuring agreement outside of the ordinary course of business? Creditor Niagra Mohawk Power Company faced this question in the bankruptcy case of *In re Ice Cream Liquidation* from the District of Connecticut, wherein the debtor sought to recover alleged preferential transfers totaling more than seven hundred thousand dollars.

In *In re Ice Cream Liquidation*, the debtor fell behind in its monthly electric payments to the creditor. The creditor sent a termination notice to the debtor, and the parties entered into an "account agreement," or restructuring agreement, establishing a repayment schedule. The debtor agreed to make large weekly payments under the agreement. At the end of the agreement, the debtor remained in default. As a result, the parties entered into a second restructuring agreement. Again, at the end of the second restructuring agreement, the debtor was in default. The parties contemplated a third restructuring agreement (there was a dispute as to whether the third agreement was ever effective between the parties), and the debtor made payments consistent with the third agreement, but again defaulted. Shortly thereafter, the debtor filed its voluntary petition.

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CHECK 21 AND FRAUD: SAY GOODBYE TO BUST-OUTS?

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A frustrating aspect of a credit professional's job is being ensnared in a planned insolvency or bust-out. Even a sophisticated credit professional who may sense credit risk with a particular account, and sell only on COD, yet 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). While payment by check is viewed as a cash sale, a check can bounce and the goods already have been delivered. Unfortunately for the credit professional who is being pressured to release goods with payment by check may have to wait days for the check to clear. The recent enactment of a federal law may change this.

On October 28, 2004, the Check Clearing for the 21st Century (Check 21 Act), federal legislation affecting all states, went into effect. Check 21 changes the method that checks are processed in the United States, as well as changes the technology of check payment and acceptance. With Check 21, financial institutions may process checks electronically, instead of transporting the paper checks. With checks being processed electronically, checks are expected to clear promptly, not in days. Indeed, a vendor may be promptly notified by the bank of an NSF check. What is the impact of Check 21 and reducing the risk of a bust-out? bad check laws? What steps does a vendor take to enforce the bad check in light of Check 21?

Overview of Check 21

Approximately 75 percent of trade credit transactions are conducted by check. Check 21 focuses on the delay caused by a paper check being transported through the banking system.

Check 21 permits the depository bank, if it so chooses, to "truncate" the original check. Truncating a check means to take the check out of physical circulation by transforming it using a computer scanner into a digital image, also known as a substitute check. This digital image becomes the legal equivalent of the original check, provided it meets the criteria set out in the legislation. Truncating the check permits banks to process the digital image for payment in hours rather than days. As a result of image technology, delays attributable to weather or air travel are gone.

FROM THE PUBLISHER:

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The Bust-Out In Action

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

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

Vendors become unwitting participants to a bust-out when they do not conduct thorough credit checks of new customers. A vendor's resources to do so often limited, while increasing competition in many fields

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Guest Column

SARBANES-OXLEY SECTION 404 IS MUCH MORE THAN TRADITIONAL CONTROLS OVER FINANCIAL REPORTING

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It took dramatic governmental intervention to draw attention to the importance of information technology (IT) controls, and now companies are learning how to cope. Section 404 of *The Sarbanes-Oxley Act of 2002* (SOX) requires public companies to document and assess their internal control structure for financial reporting, and their external auditors to opine on that assessment as well as the effectiveness of those controls. While the Foreign Corrupt Practices Act of 1977 has historically required public companies to have sound controls over their financial reporting, it was not until SOX and the 404 external audit requirement that many companies have taken notice.

First of all, it is important to paint a clear picture of the current environment. Even though the SOX legislation is approaching its third birthday, there are still many unknowns and a lack of precedence. As a result, virtually everyone from the boardroom, management and audit firms is apprehensive, perhaps even a bit paranoid, about those two little paragraphs consisting of Section 404 entitled "Management Assessment of Internal Controls." Even the Securities and Exchange Commission (SEC) and the non-profit organization created by SOX, the Public Company Accounting Oversight Board (PCAOB), are challenged to meet this new environment. New standards, a lack of qualified staffing, conflicting legal advice, miss-information, rising costs, a continuing parade of SEC and PCAOB guidance, and anticipated Committee of Sponsoring Organizations of the Treadway Commission (COSO) guidance for small companies due this summer, promises to keep things interesting for a while.

> *Possible Side Bar*: Section 404 requires public companies (those organizations who file reports to the SEC under the Securities Exchange Act of 1934) to report annually on

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A vendor sued for a preference for an amount less than $5,000 poses special problems for the vendor. For the vendor to employ counsel and defend the preference lawsuit may not be cost effective, even if the vendor has valid defenses. Preference suits in this dollar range appear from the vendor's viewpoint as a "shake down" and the beneficiaries of these preference actions appear to be the trustee's professionals. The 2005 Act provides that $500 is the minimum preference action that may be pursued.

a. What It Means For Vendors

This change protects smaller vendors most prone to abusive litigation tactics, and the $5,000 threshold amount does not undermine the policy supporting equality of treatment of like creditors.

3. Venue Change: Suing The Vendor Where It Has Its Principal Place Of Business (Section 410)

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 inconvenient, and more costly to defend. The 2005 Act requires 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.

a. What It Means For Vendors

This change protects vendors from a trustee taking advantage that it will cost the vendor more to litigate the preference given the inconvenient forum. This change of forcing the trustee to litigate in the vendor=s home court for amounts between $5,000 to $10,000, should require the trustee to carefully consider a vendor's defenses, such as the new value and ordinary course of business before filing suit in a foreign court.

4. Amending The Ordinary Course Of Business Exception (Section 409)

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 both 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.

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 2005 Act makes it easier for the vendor to prove up the ordinary course of business defense by allowing the vendor to establish either that the payment was ordinary between the debtor and the vendor, or that the payment was ordinary in comparison to the terms in the industry. The vendor is no longer required to prove both elements.

a. What It Means For Vendors

This provision strengthens the ordinary course of business defense. Provided the debt is incurred in the ordinary course of business, the vendor should prevail assuming that either the payment was in the ordinary course of business between the vendor and the debtor, or that the payment was made according to ordinary business terms.

5. Extended Period For Creditors to Perfect Security Interest (Section 403)

The 2005 Act provides a creditor up to 30 days to perfect their lien, thereby reducing the risk that a vendor's act of recording a security interest during the preference period may be challenged as a preference.

a. What It Means For Vendors

Vendors that take a security interest, consignment, or purchase money security interest in the goods they sell are subject to the preference laws, as such transactions are transfers under the preference laws. With the extended period to perfect a security interest, vendors are given greater protection from a preference challenge.

C. Rewriting The Fraudulent Conveyance Laws

1. What Is A Fraudulent Conveyance? (Section 548)

A debtor, whether individual, corporation, LLC or partnership, may devise a scheme to channel assets from creditors. Under state and federal law, these types of transfers are referred to as intentional fraudulent transfers. Under Section 548 of the Bankruptcy Code, a trustee may attack a transfer made within a year of the bankruptcy filing.

2. Reach Back Period Extended (Section 548)

The 2005 Act permits assets that are fraudulently transferred within two years of the bankruptcy filing to be recaptured. The 2005 Act also permits recapture of fraudulent transfers to trusts within 10 years of the bankruptcy filing.

a. What It Means For Vendors

Creditors and trustees are given a greater opportunity to recapture assets that were fraudulently transferred, thereby increasing the distribution to vendors.

D. Rewriting The Involuntary Bankruptcy Petition Law

1. What Is An Involuntary Bankruptcy Petition? (Section 303)

The purpose of involuntary bankruptcy is to provide vendors with a means of assuring equal distribution of the debtor's assets. In addition, an involuntary proceeding may benefit vendors (once an order for relief is entered) as a trustee can use the Bankruptcy Code's avoidance powers to recapture fraudulent conveyances, preferential transfers and unseat improperly perfected liens.

2. Vendor's Debt Must Not Be Subject To A Bonafide Dispute (Section 1234)

A creditor whose claim is subject to a bona fide dispute as to liability or amount may not be a petitioner in an involuntary bankruptcy case.

a. What It Means For Vendors

Under this provision, a creditor may be

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disqualified as a petitioning creditor where there is a legitimate basis for the debtor not paying the debt or disputing the amount. The policy for excluding claims subject to a bona fide dispute is to prevent creditors from using involuntary bankruptcy to coerce the debtor to pay debts which the debtor has legitimate defenses. If the court finds there is a bona fide dispute to a claim, the petitioning creditor does not qualify, and the petition must be dismissed, unless another qualified creditor is permitted to join the involuntary petition. To reduce the risk that it may be disqualified as a petitioning creditor, the vendor may consider including language in their credit application that forces the debtor to timely inspect the goods shipped:

> "Applicant also agrees to examine immediately upon receipt, each of *[Creditor]*'s statements, and to advise *[Creditor]* of any disputed transactions or statements within 10 days of receipt, together with a written statement specifying the reasons for such dispute. Failure to notify *[Creditor]* of any dispute with respect to defective goods shall constitute a waiver of all such disputes."

E. Rewriting The Reclamation Law (Sections 406 and 1227)

The 2005 Act reforms the reclamation laws in the following ways.

1. What Is Reclamation? (Section 546)

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. The Bankruptcy Code, section 546, adopts the UCC, but is modified. The Bankruptcy Code before the 2005 Act was signed into law required (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.

While the Bankruptcy Code still requires the vendor's demand for reclamation in writing, the notice period has been significantly lengthened. 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 order that the goods remain with the debtor to help reorganize.

2. Administrative Claim For Goods Shipped Within 20 Days (Section 1227)

This provision gives vendors an administrative clam for goods shipped in the ordinary course of the debtor's business within 20 days prior to bankruptcy.

a. What It Means For Vendors

Vendors which ship goods within 20 days of the debtor filing bankruptcy no longer have to establish the validity of their reclamation claims. As the reclamation claim is given administrative priority, the vendor is entitled to payment in full on the reclamation claim under a Chapter 11.

3. Extending The Reclamation Demand Period To 45 Days (Section 1227)

If a vendor makes a reclamation demand within 45 days after the debtor receives goods, the debtor must pay for, or return the goods, and that the substitution of a lien or administrative expense claim in lieu of payment is no longer sufficient. In addition, if the 45 days extends beyond the petition date, then the deadline for the receipt of notice by the debtor is 20 days after the bankruptcy filing. If the vendor fails to give timely notice to the debtor, the vendor has an administrative expense claim so long as the goods were received by the debtor within 20 days prior to the petit ion date.

a. What It Means For Vendors

Prior to the 2005 Reform Act, the Bankruptcy Code provided the bankruptcy court with the ability to grant a vendor a lien or priority claim in lieu of the vendor reclaiming the goods. This provision allowed the court to require that the goods remain with the debtor to help it reorganize. The 2005 Act no longer permits the bankruptcy court to provide a priority claim or lien, when the court does not allow the vendor to reclaim the goods.

Provided the vendor can establish the elements of a reclamation claim, the extension of the reclamation period to 45 days may open the door to significantly more types of goods to be reclaimed, and lead to larger administrative claims asserted by vendors. However, larger administrative claims may pose a risk that a debtor may not be able to pay these administrative claims, and thus jeopardize its exit from bankruptcy.

4. Rights Of Floating Lienholders

A vendor's reclamation rights are now specifically subject to the preexisting rights of a secured creditor that claims a security interest in the debtor's after-acquired inventory.

a. What It Means For Vendors

Where a vendor has delivered goods to the vendor during the reclamation period, the vendor's reclamation claim is lost should the debtor's pre-existing secured creditor be undersecured.

5. Paying Off The Reclaiming Creditor in Chapter 11

Given the automatic administrative claim given to reclaiming creditors for those goods shipped within 20 days prior to bankruptcy, vendors may now push for early payment of their reclamation claim, as it has administrative priority.

F. Rewriting The Small Business Bankruptcy Law Provision (Sections 431 and 432)

The 2005 Act reforms the small business bankruptcy law provision in the following ways.

1. What Is A Small Business Bankruptcy? (Section 432)

Under the Bankruptcy Reform Act of 1994, Congress established a fast track for small business reorganizations for the pur-

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pose of making business reorganization less complex and expensive in Chapter 11. A debtor must first elect to be considered a small business debtor. A small business is defined as one whose non-contingent liquidated, secured and unsecured debts are less than $2 million as of the bankruptcy filing.

2. Plan Confirmation Expedited (Section 437)

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 of the bankruptcy filing. The debtor has a maximum of 150 days from the petition date to have its plan confirmed. If a plan is not confirmed within this time, the case may be converted to Chapter 7, or dismissed. If no plan is proposed within 300 days, the case can be converted to Chapter 7 or dismissed.

3. New Reporting Requirements And Additional Duties of the Debtor (Section 434 and 436)

A debtor must file reports as to their profitability, projected cash receipts and disbursements, and comparisons with earlier reports. With a Chapter 11 filing, the debtor must file a recent balance sheet, statement of operations, cash-flow statement and federal income tax return. The debtor must attend all scheduled court and United States Trustee meetings. The debtor must timely file all schedules, statements, and reports unless granted an extension. The debtor must maintain insurance, and timely file all tax returns and other governmental filings.

a. What It Means For Vendors

A small-business Chapter 11 debtor is now required to provide more expansive and timely financial information as to its post-bankruptcy operations. This financial information may assist creditors in determining whether the debtor should continue to operate, whether management should be replaced and the timing for exiting Chapter 11. This financial reporting may also prompt some small debtors to stay clear of bankruptcy because of the financial reporting scrutiny.

G. Reviewing An Individual Debtor's Ability to Pay: The "Means Test" (Section 707)

The 2005 Act makes it more difficult for individuals to file for Chapter 7 by imposing a means test, which determines whether a debtor has the ability to repay a significant portion of their debts.

The 2005 Act employs a "means test" to determine whether an individual qualifies to file a case under chapter 7, and to determine whether, once filed, a chapter 7 case may be dismissed or converted based upon abuse of the bankruptcy system. Means testing will be employed to determine whether an individual debtor's average currently monthly income is more or less than the median income in the state where the debtor resides.

If, after computing currently monthly income, and deducting certain living expenses, and multiplying that amount by 60, the monthly income exceeds the lesser of (i) $10,000; or (ii) the greater of 25% of the debtor's unsecured nonpriority claims or $6,000, than the debtor is presumed to be abusing the bankruptcy process by filing a chapter 7 case. If it is determined that a debtor is able to repay their debts, then the Chapter 7 case may be dismissed or converted to Chapter 13.

a. What It Means For Vendors

For a vendor holding a personal guarantee the means test may force the guarantor to repay a portion of the guaranteed debt through a Chapter 13 bankruptcy filing if the guarantor's income is too great. Likewise, for a vendor selling to a sole proprietor, the debtor may consider filing an individual Chapter 7. Should the sole proprietor's monthly income exceed the mean, the Chapter 7 case may be dismissed or converted to Chapter 13.

H. Expansion Of Bankruptcy Court's Power Over Creditors' Committees

1. What Is A Creditors' Committee? (Sections 1102 and 1103)

Most operating companies in Chapter 11 have a creditors' committee appointed. Perhaps the best way for a vendor to protect its interests in the Chapter 11 and obtain cost-effective legal representation is to serve on the creditors' committee. The committee usually consists of five or seven members selected from the largest unsecured creditors of the debtor. Members are appointed by the United States Trustee, an arm of the Department of Justice, based upon requests to serve from creditors. The committee may hire legal counsel and financial consultants, and have the cost paid by the debtor.

The committee is responsible for protecting the interests of general unsecured creditors. This may include investigating the debtor's past transactions, overseeing the debtor's operations and monitoring its postbankruptcy operations and progress towards a reorganization plan. The committee also has standing to negotiate the debtor's plan of reorganization, to recommend to creditors whether to vote in favor or against the plan, and to even file its own plan of reorganization.

2. Bankruptcy Court's Power Over Creditors' Committees (Section 405)

Prior to the 2005 Act, the U.S. Trustee appointed the credtiors' committee, in addition to changing the membership of the committee. The 2005 Act provides the bankruptcy court with the authority to direct, after a request from a party in interest, the U.S. Trustee to change the membership of a committee, or increase the number of members of a committee to include a creditor that is a small business. This provision gives creditors the right to request the court to serve on the committee.

The responsibilities of creditors' committee members is also expanded. A committee now has to provide bankruptcy case information, as well as solicit feedback from creditors with similar claims that are not appointed to the committee.

a. What It Means For Vendors

The bankruptcy court's ability to change the composition of a creditors' committee, or appoint an additional creditors' committee, may make creditor involvement more effective. The provision that the committee must now share information from non-committee members may be difficult where the committee has signed a confidentiality agreement with debtor. Likewise, this

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provision does not set out the kind of information it must seek from non-committee members to comply. This provision allows small businesses to have a larger role in how a reorganization or liquidation of a debtor is handled.

I. Debtor Protecting Assets: Asset Protection Trusts, Homestead Exemptions And Retirement Funds

Notwithstanding additional protections afforded creditors under the 2005 Act, a debtor still may be able to shelter assets from creditors and the bankruptcy trustee, including asset protection trusts, homestead exemptions and IRA's.

1. Asset Protection Trusts

The 2005 Act does not address debtors placing assets in asset protection trusts. Debtors can establish trusts in Alabama, Delaware, Nevada, Rhode Island and Utah by residents and nonresidents. A foreign asset protection trust exists via offshore legislation which allows the trusts to be formed and controlled by the person or entity which forms the trust. These trusts also include numerous provisions meant to prevent vendors from collecting outstanding balances by shortening the statute of limitations. The flight provisions allow the debtor to move the trust when the trust is being attacked in the jurisdiction the trust was established.

a. What It Means For Vendors

From a creditor's perspective, these trusts attempt to thwart attempts to pay a judgment, or bring assets into the estate of the debtor for distribution in a bankruptcy proceeding. The assets in these trusts may escape a creditor's reach. Whether a bankruptcy court determines the assets to be part of the debtor's estate or not, vendors will incur more legal fees and endure more litigation as a result of asset trusts. These trusts are another layer to prevent a vendor from receiving timely and full payment on a judgment.

2. Homestead Exemptions (Section 322)

Florida, Iowa, Kansas, South Dakota and Texas have unlimited homestead exemptions that allow the wealthy to file for bankruptcy and keep their mansions in those states sheltered from creditors. The 2005 Act restricts the homestead exemption in states to $125,000 if the person in bankruptcy bought his or her residence less than three years and four months before filing. This provision also disallows the homestead exemption if the debtor purchased the property with the intent to defraud creditors.

a. What It Means For Vendors

Prior to the 2005 Act, debtors could shield their assets from creditors by moving, to, say, Texas or Florida and purchasing a house with all of their assets and filing for bankruptcy. This provision now protects creditors from this risk.

3. Retirement Funds

The 2005 Act increases a debtor's exemption of retirement funds from creditors to $1 million.

a. What It Means For Vendors

A vendor should be mindful that when considering a guarantor's or sole proprietor's personal financial statements that a listing of an IRA does not mean that these assets can be used to pay a creditor's judgment.

J. Earlier Filing Of Plan Of Reorganization

1. What Is A Plan Of Reorganization? (Sections 1112 through 1129)

The plan of reorganization is an agreement between the debtor and its creditors that provide for rewriting the prepetition debts of the debtor and repayment of those debts. While creditors can agree to a plan that provides for virtually any kind of treatment, there are certain mandatory 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.

2. Earlier Filing Of Plan Of Reorganization (Section 411)

Prior to the 2005 Act, a debtor had the exclusive right to file a plan within the first 120 days, and an additional 60 days to solicit acceptances of the plan. A bankruptcy court could extend the exclusivity period indefinitely upon a showing of "cause". The 2005 Act limits the time a debtor has the exclusive right to propose a plan of reorganization to 18 months. After that, there can be competing plans from creditors and creditors' committees.

a. What It Means For Vendors

The 2005 Act's cutting off of a debtor's extensions of plan exclusivity may result in more creditor and committee plans being filed. Given that debtors can no longer have their exclusivity extended, creditors and committees may hang back from negotiating with a debtor to formulate a consensual plan. In large Chapter 11's, with many tiers of debt, the debtor may have limited time to confirm a plan in negotiating with these creditor groups.

K. Early Assumption Of Real Estate Leases (Section 309)

The 2005 Act requires a debtor to assume or reject its real estate lease within 120 days following the petition date. A court may extend the 120 day period to assume or reject for up to an additional 90 days. Further extensions require the lessor's consent.

a. What It Means For Vendors

The 2005 Act changes the way in which a debtor deals with assumption or rejection of its unexpired real estate lease. Prior to the Reform Act, a debtor had 60 days from the bankruptcy filing to decide whether to assume or reject its commercial real estate lease. A bankruptcy court routinely extended this time during the course of the bankruptcy case.

The consequences of forcing the debtor to decide to assume or reject a real estate lease by an earlier deadline, may drive up the administrative cost of a chapter 11 case and jeopardize its reorganization. A debtor may be forced to prematurely assume, and to continue to pay the rent, only to determine later that the early assumption

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was wrong. The 2005 Act attempts to limit the mistake of early assumption by limiting the administrative claim a landlord may assert if the debtor later rejects a real estate lease it had assumed. This provision imposes a two year cap on the amount of the administrative claim a landlord may recover.

L. Adequate Assurance To Utilities (Section 417)

This provision attempts to resolve what constitutes adequate assurance of payment for a utility. A debtor offering a utility administrative expense claim no longer constitutes adequate assurance of payment. The time by which a debtor must provide adequate assurance to a utility is extended to 30 days, from 20 days, but what is adequate assurance is limited. This provision defines the term adequate assurance of payment as: a cash deposit; a letter of credit; a certificate of deposit; a surety bond; a prepayment of utility consumption; or another form of security that is mutually agreed on between the utility and the debtor or the trustee. Prior to the 2005 Act, there was much litigation between the debtors and their utilities, including telecom debtors and the telephone utilities, as to how to provide assurance of payment to the creditors.

The utility may alter or refuse service if, during the 30 day period beginning on the date of the filing of the petition, the utility does not receive from the debtor adequate assurance for service that is satisfactory. The utility may also setoff against a security deposit provided to the utility by the debtor prior to the bankruptcy.

a. What It Means For Vendors

This provision requires debtors to provide utilities with cash deposits or credit enhancements during the early stage of the Chapter 11. The debtor will be required to have more assets available to satisfy a utilitiy's adequate assurance requirements. The debtor is still protected from the immediate termination of services.

M. Appointment Of Chapter 11 Trustee Or Conversion Or Dismissal of Case (Section 442)

1. Management Continues To Operate Chapter 11 Debtor (Section 1104)

Under Chapter 11, it is presumed that the debtor will remain in possession and current management will continue to manage its affairs. The filing of bankruptcy, insolvency, and poor business decisions are insufficient to oust management. The debtor's officers need not be employed by the bankruptcy court.

2. Additional Grounds To Convert Or Dismiss A Case (Section 442)

Prior to the 2005 Act, the bankruptcy court may convert a Chapter 11 to Chapter 7 liquidation or dismiss the case upon a showing of cause.

This provision requires the bankruptcy court to convert or dismiss a case if a party seeking conversion of dismissal establishes "cause". Several new grounds for showing "cause" are set forth, including gross mismanagement and unauthorized use of cash collateral.

3. Appointment Of Trustee Where Fraud Suspected (Section 1405)

In cases of suspected fraud, the U.S. Trustee must seek the appointment of a trustee to replace management.

a. What It Means For Vendors

This provision is prompted by the Enron line of bankruptcies and the concern of corporate fraud. Given that the U.S. Trustee is directed to seek appointment of a trustee on mere suspicion of fraud, creditors my see more requests of the court to appoint a trustee. This will lead to more litigation and expense, as management opposes the request to stay in control.

N. Debtor's Lawyer's Responsibility To Creditors

1. Burden To Confirm Debtors' Financial Condition (Section 319)

The 2005 Act may leave attorneys for individual attorneys subject to court sanctions if they can't prove the effort they made to check the debtor's bankruptcy schedules and statement of financial affairs.

Fact checking may entail everything from hiring a private investigator, to verifying a client's debts, to hiring an appraiser to confirm the value of a debtor's home.

The 2005 Act requires attorneys for individual debtors to certify their clients' financial statements to the court and will be held financially responsible if the statements are false. The 2005 Act may hold attorneys for individual debtors liable for mistakes such as a debtor reporting fewer assets than they have. Attorneys may also be subject to sanctions if inaccuracies in a debtor's schedules results in the dismissal of the debtor's Chapter 7 petition or in its conversion to a Chapter 13 petition.

O. Limitations On Key Employee Retention/Severance Programs (Section 503)

Prior to the 2005 Reform Act, corporate debtors in the opening days of the Chapter 11 filing would often request that the bankruptcy court approve a bonus scheme for management. Vendors would often view such requests by management as overreaching and an attempt by management to enrich themselves at the expense of creditors. Under the 2005 Act, in order to obtain approval of a key employee retention plan, the debtor must establish that a retention of stay bonus is essential to induce the insider to continue their employment. For the insider to become entitled to such a bonus, he or she must have a job offer from another business. In addition, the insider's services must be essential to the business. Under this section, the range of acceptable retention bonuses and severance pay for such insiders is linked to the bonuses and severance packages that are available to non-management employees. Thus, even if it is proven that the key person is essential to the success of the debtor, and that this person has another equal or better opportunity awaiting him or her, the retention bonus and severance package cannot exceed ten times the amount paid to non-management persons within the year in which the transfer is made or, in the absence of such non-management bonuses, cannot exceed 25 percent of the amount of bonuses transferred to the insider himself during the year prior to the retention bonus.

a. What It Means For Vendors

Vendors, on the one hand, may view

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CHECK 21 AND FRAUD: SAY GOODBYE TO BUST-OUTS?

(*Continued from page 2*)

has pushed large numbers of vendors to relax their credit standards. Unsuspecting companies of any size, including Fortune 500 companies, are vulnerable to bust-out schemes.

Some large companies have sophisticated credit departments, yet even some of these become lax when an order involves five-digit or six-digit amounts. The bust-out operator takes possession of the 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. The bust-out operator then sells the goods at steepbig discounts in return for immediate cash, and files for bankruptcy liquidation or merely disappears. Far from being experienced businessmen who have stepped over the line in their business decisions, bustbut-out operators are usually members of criminal rings that operate for the sole purpose of defrauding vendors.

Reduced Risk of Goodbye To Bust-Outs with Check 21?

With Check 21, vendors may be able to confirm whether the check is good prior to releasing the shipment or while the goods are in transit as a result of cutting the float. With Check 21, the credit professional may find receiving a check akin to a customer paying by credit card. While a payment by check will not result in a simultaneous transfer of funds, with Check 21 it may allow the supplier to avoid being ensnared in a bust-out.

Further, as the vendor may insist on cash in advance sale, Check 21 will assist the vendor. In a potential bust-out, the credit professional may find the customer (as well as its sales force) pressuring them to release the goods prior to the check clearing the bank. Check 21 may ease the pressure of holding the order given that the vendor should get prompt notice of the check clearing—or not.

A common way for an unscrupulous businessperson to take advantage of a vendor is a bust-out scheme. A bust-out scheme is devised to defraud vendors of their merchandise through the use of planned bankruptcies and business failures. Bust-out schemes are usually orchestrated in two stages.

In the first stage, the usual practice of bust-out operators is to create a fake corporation, establish a credit account with one or more vendors, place small purchases, and pay within invoice terms on the limited credit provided. In this way, the bust-out operator establishes good credit (i.e., credit worthiness) with vendors.

In the second stage of the bust-out, the execution, the operator places large orders on open account with as many suppliers as possible. He or she then sells the merchandise at steep discounts in return for cash, and often merely disappears. Traditionally the best way for credit executives to avoid a bust-out scheme was conducting a thorough investigation of the company. Check 21 will substantially thwart efforts of unscrupulous businesspersons.

With Check 21, suppliers may be able to confirm whether the check is good prior to releasing the shipment, or while the goods are in transit. With Check 21, the credit professional may find receiving a check akin to a customer paying by credit card. While a payment by check will not result in a simultaneous transfer of funds, with Check 21 it may allow the supplier to avoid being ensnared in a bust out.

A Vendor's Due Diligence

Even with the arrival of Check 21, due diligence is crucial for the credit professional wishing to avoid a bust-out. There are red flags in a bust-out that a credit professional should attempt to identify in the course of their transactions. This can limit the risk of selling into a bust-out. Common red flags include a fake company name that is similar to the name of a well-established company. Another flag is unusually large profits depicted on the income statement -- if that statement is even provided. Indeed, it may be delivered to an address other than the business address. Finally, a large merchandise order following a history of small orders should raise a question for a credit professional dealing with a relatively new vendor.

There are several steps credit execu-

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THE BANKRUPTCY REFORM ACT OF 2005:

WHAT IT MEANS TO THE CREDIT AND FINANCIAL PROFESSIONAL

(*Continued from page 7*)

the restrictions as a sensible balance to force debtor's management to be more accountable to creditor interests. Management, on the other hand, view these restrictions negatively and lead to the departure of management that may be essential to a debtor reorganizing. In particular, requiring that management comparable job offers to be eligible for retention bonuses may induce management, it may be argued, to search for a new job at a time when they should be focused on the debtor's reorganization.

P. Impact on Bankruptcy Judges

1. More Bankruptcy Judges

The 2005 Act provides some relief for bankruptcy courts by funding 28 new judgeships. Delaware will continue and likely expand as the favored venue of large corporate Chapter 11 filings, with the addition of four new judges.

This article to be published by the Credit Research Foundation.

RESTRUCTURING AGREEMENTS AND THE ORDINARY COURSE OF BUSINESS DEFENSE

(*Continued from page 1*)

The debtor commenced an adversary action against the creditor to recover the alleged preferential transfers. The creditor asserted, among other defenses, that the payments were made in the ordinary course of business and filed a motion for summary judgment seeking dismissal of the action. The debtor filed a cross-motion for summary judgment against the creditor.

The creditor asserted as part of its ordinary course of business defense that it was standard in the industry for parties to enter into restructuring agreements. In support, the creditor claimed that it was required to enter into the restructuring agreement pursuant to the industry regulations. The court stated that payments made pursuant to a restructuring agreement in accordance with industry regulations were per se *within* industry standard. The court made a special note of the requirement under the regulations that the restructuring agreement be made on more generous terms – a fact that other courts have also referenced. The court held, however, that there was a question of fact as to whether the restructuring agreement comported with the proper regulatory procedure, denied both parties' motions and required a trial on the merits.

In the end, the *Ice Cream* court's decision gives more support to creditors faced with a decision of whether or not to restructure the obligation of a troubled debtor. While there have been recent decisions holding that restructuring agreements are not per se out of the ordinary course of business, the *Ice Cream* decision goes one significant step further by recognizing that a restructuring agreement may be per se within the industry standard, should it comply with industry regulations. Certainly, most defendants are not required to enter restructuring agreements under industry regulations. But the *Ice Cream* case illustrates that bankruptcy judges are thawing to the reality that restructuring agreements may be ordinary within an industry, and payments made pursuant to such agreements are within the ordinary course of business.

CHECK 21 AND FRAUD: SAY GOODBYE TO BUST-OUTS?

(*Continued from page 8*)

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

Downside with the Bust-out

In the event the vendor has released the goods into a bust-out, the vendor can expect to suffer losses, as successful, cost-effective legal remedies are limited for a vendor. After a vendor has sold into a bust-out, it is extremely difficult to recover the goods or to satisfy a monetary judgment against the bust-out operator.

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

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

Check 21 Will Help the VendorWhen the business failure includes a bankruptcy filing, a vendor's legal remedies are also limited. The vendor may be able to convince the bankruptcy trustee of the failed business to pursue the buyers of the discounted merchandise under a fraudulent conveyance theory. The trustee would, however, need funding to pursue such litigation. A vendor may attempt to block the discharge of its claim in the bankruptcy by filing a complaint to determine the dischargability of its debt where the operator has filed an individual bankruptcy. In either situation, the vendor still faces the problem of locating the operator's assets.

Even with the arrival of Check 21, credit professionals must be vigilant for red flags indicating a risk of a bust out. Although Check 21 may provide the credit professional with an early warning of an NSF check, if the goods have been shipped and cannot be reclaimed, the vendor will likely be unable to recover the goods. However, with Check 21 and a cut in the float timeAnother means of combating a bust-out is to refer the bust-out to the United States Attorney's Office, the District Attorney, of if the case is in bankruptcy, the Office of the Untied States Trustee. The U. S. Trustee is an adjunct of the Justice Department and has the responsibility of working with the U.S. Attorney's Office to investigate bankruptcy crimes. The Bankruptcy Reform Act of 1994 established new criminal penalties for any person fraudulently using a bankruptcy filing to discharge debts.

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

SARBANES-OXLEY SECTION 404 IS MUCH MORE THAN TRADITIONAL CONTROLS OVER FINANCIAL REPORTING

(*Continued from page 2*)

the effectiveness of their internal controls over financial reporting. It also requires their independent auditor to render an opinion on management's conclusions, as well as render a separate opinion on the effectiveness of management's controls. In addition to the annual management evaluation under 404, it is important to remember that Section 302 requires management to evaluate disclosure controls on a quarterly basis. The vast majority of controls over financial reporting also fall within the scope of disclosure controls, and hence Section 302, through the financial statements contained in a company's 10-Q and 10-K filings.

Further, while most large and midsize companies have already filed their initial 404 report and are entering their second year of 404 requirements, smaller companies, defined as having a public float of under $75 million at the close of their second quarter, have not even entered their initial fiscal year subject to 404 requirements. Thanks to a one-year reprieve granted by the SEC on March 2, 2005, these smaller companies, otherwise known as "non-accelerated filers," and all foreign private issuers do not need to comply with 404 until their fiscal year ending on or after July 15, 2006. Although this may seem like a long way off, non-accelerated filers and foreign private issuers are well advised to be underway on the 404 front, especially in light of the approximately 300 larger companies who had to ask for extensions in filing their 10-K's as of late March of this year. While not all of these late filings cited Section 404 as the cause, many did.

Finally, and perhaps most importantly, is confusion, or even non-awareness, over the scope of 404. PCAOB's auditing standard #2 (AS2) makes it clear that all five components of COSO's "Internal Control – Integrated Framework" are in scope. This means that companies are responsible for documenting, evaluating, and reporting upon their controls over financial reporting using a suitable control framework, such as the COSO framework, that addresses:

- Control Environment,
- Risk Assessment,
- Control Activities,
- Information and Communication, and
- Monitoring.

In addition, external auditors are responsible for testing and opining upon the company's internal control over financial reporting, including all five COSO framework components.

This is often new territory for both internal and external auditors since most of these components are not the traditional accounting controls we commonly think about, such as approvals, verifications, reconciliations, physical security of assets, and separation of duties. Accounting controls are primarily "control activities" defined by COSO as policies and procedures, and characteristic of "hard" controls, which are much easier to document and test. While control activities are clearly an important part of 404, entity-level controls largely represent the four other COSO components. Examples of entity-level control areas include management and employee competence, audit committee participation, management's philosophy, integrity and ethical values, which are often challenging and illusive to document and test. These are considered "soft" areas since validation often needs to be accomplished through inquiry and observation.

A simple way to theoretically think about the scope of 404 is through the concept of the "big-3." The big-3 represents traditional accounting controls, entity-level controls, and IT controls. These three scope areas are inter-related, yet very different in many respects. A material weakness in any one of these three areas means an adverse opinion if not remediated by the end of the company's fiscal year in which they are subject to Section 404 requirements.

Let's face it, entity-level and IT controls have not been a traditional focus of education in our business schools, or training through companies or public accounting firms. This is now changing, but the learning curve is not necessarily easy as voiced by companies and auditors alike in response to 404 challenges and escalating costs. A company's control environment through its "tone-at-the-top" is widely considered the foundation of all controls, yet it is the most challenging of the big-3. COSO's framework defines control environment as "an atmosphere in which people conduct their activities and carry out their control responsibilities." Documenting, testing and reporting upon an atmosphere is new territory for many. Fortunately, the COSO framework provides some solid guidance in accomplishing this feat.

While the COSO framework is a strong tool for addressing entity-wide and traditional accounting controls over financial reporting, it is somewhat shallow on the IT front. Therefore, a supplemental IT framework is helpful to internal and external auditors alike to help ensure compliance and enhance performance. One of the more popular frameworks for 404 purposes is Control Objectives for Information and related Technology (COBIT). The IT Governance Institute (ITGI) has the leading role for COBIT. The Information Systems Audit and Control Association (ISACA) is the mother organization to ITGI and issued a report last summer entitled "IT Control Objectives for Sarbanes-Oxley." This report reconciles COBIT with COSO and AS2. The report can be accessed at ISACA's website, www.isaca.org.

IT controls probably come in a close second after entity-level controls in terms of difficulty to document and test. Similar to a company's control environment, IT has its own entity-level controls that have a pervasive effect on the achievement of effective controls over financial reporting. This includes IT strategic planning, information architecture, risk assessments, training, and monitoring of technology. In addition, IT general controls and application controls may all be within the scope of 404. Activity level general controls, such as controls over security, software testing, change management, data management, and managing third-party services are receiving plenty of attention from external auditors per direction of AS2. Specifically, paragraph #50 states that "general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively."

Finally, application controls, such as access, data-validation, error reporting, and interfaces are pertinent to the achievement of financial reporting control objectives.

(*Continued on page 11*)

SARBANES-OXLEY SECTION 404 IS MUCH MORE THAN TRADITIONAL CONTROLS OVER FINANCIAL REPORTING

(*Continued from page 10*)

Application controls often exposes a common challenge within companies. Oftentimes, the IT department and controllership function are not the best of friends since they sometimes have different goals and do not understand each other's worlds. Accountants often want information quickly and do not understand the "black-box" of IT. IT folks want ample lead-time to information requests so they can perform adequate quality assurance. They speak different languages as GAAP and software coding are worlds apart. Yet, application controls is by definition that intersection between IT and accounting which forces the two sides to closely work together if they hope to be successful on the 404 front. To this end, IT professionals need to be well versed in internal control theory and practice. Specifically, CIO's should take the leadership reins by:

- enhancing their knowledge of internal controls,
- understanding their company's overall SOX compliance plan,
- developing a compliance plan to specifically address IT controls,
- aligning the appropriate resources, and
- executing their compliance plan in harmony with the company-wide SOX plan.

While it is the CEO's and CFO's signatures on the quarterly and annual SOX certifications, a strong argument can be made that the CIO's signature should have also been written into the legislation. Each of these three individuals lead a component of the big-3, and each are critical to the ultimate success of 404.

Ronald Kral, MBA, CPA, CMA: Ronald is a Partner of Candela Solutions, LLC, a public accounting firm based in Madison, WI. Ronald is a thought-leader on governance, business ethics, internal controls, and *The Sarbanes-Oxley Act of 2002*, including the COSO and COBIT frameworks, NYSE & NASDAQ rules, PCAOB standards, and SEC regulations. He is a member of the AICPA, FEI, IMA, ISACA and WICPA. Ronald holds an MBA from Arizona State University and a BBA from the University of Wisconsin. He can be reached at rkral@candelasolutions.com. His website can be found at www.candelasolutions.com

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Summer 2005

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

◊ Scott spoke to **NACM/Chicago-Midwest's Agricultural Industry Group** in San Francisco regarding **Check 21.**

◊ Scott spoke to **NACM/Tampa's Industry Group** regarding **Sarbanes Oxley** and **Creditors' Rights.**

◊ Scott spoke to **Reimer Reporting's Industry Group** in Phoenix regarding **Check 21.**

◊ Scott spoke to **NACM National's** members regarding **What's Hot with Credit Applications.**

◊ Scott spoke to **IOMA's** members regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke at the **CMA Business Credit Services Annual Meeting** regarding **Check 21**.

◊ Scott spoke to **NACM/Chicago-Midwest's Industry Group** in New Orleans regarding **Commercial Law Developments.**

◊ Scott spoke to **BPCA's Industry Group** in Las Vegas regarding **Privacy Rights of Customers.**

◊ Scott spoke to the **Southern Nevada Institute of Credit** regarding the **Bankruptcy Amendments** and **Check 21.**

◊ Scott spoke to the **Credit Exchange's Aerospace Suppliers Industry Group** in Las Vegas regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke to the **Orange County Credit Professionals** regarding **Privacy Rights of Customers.**

◊ Scott spoke to **NACM/Kansas City's Food Manufacturers Industry Group** in Chicago regarding the **Bankruptcy Amendments** and the **Patriot Act.**

◊ Scott spoke to **What's Working in Credit's** members concerning the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke on a teleconference regarding **What's Working in Credit** and **Bankruptcy Amendments.**

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