Blakeley & Blakeley LLP

Summer 2007
www.bandblaw.com

THE TRADE VENDOR QUARTERLY

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

USING ALL OF YOUR "TRICKS" TO BE PAID NOW, AND IN FULL, WHEN YOUR CUSTOMER FILES BANKRUPTCY

Scott Blakeley
seb@bandblaw.com

Robert Meza
RMeza@ccivalve.com

We hate delay. As the credit department continues to go electronic resulting in instant access to evaluate credit risk, as the pressure from customers and the salesforce to make prompt credit decisions continues to accelerate with constant emails (all about customer service), and as the credit professional repeatedly prompt customers to honor payment terms, the credit professional is tested daily with the fast pace in the credit department in the Internet era. However, if a customer files Chapter 11 Bankruptcy, the fast pace of prolonged, uncertain payment setting when a customer files, and find a way of attempting to collect the account must be abandoned because of the automatic stay.

One of the noted effects of a Chapter 11 is that vendors suffer long delays before receiving payment on their prepetition unsecured claims, and often receive but a fraction of what they are owed. Indeed, it is common for vendors to be paid with the reorganized debtor's stock for those debtors that exist as a going concern. Does a vendor have any "tricks" that may get them out of this attempting paid today, and in full. CCI, a trade vendor, that commonly sells on credit terms, was recently hit with two significant customers that filed Chapter 11 within days of one another. In this article, we share "tricks" that resulted in being promptly paid in full in both bankruptcies.

The Trade Relationship

CCI designs and manufactures valves for use in the power industry, whose typical customers are power plants located throughout the world. In September, 2006, two of CCI's largest customers each filed Chapter 11, Deltak, which is a subsidiary to Global Power Equipment, and Magnolia Energy L. P. With the Deltak customer, CCI's mid-six figure balance included a significant portion of goods shipped a few days prior to the bankruptcy filing. With the Magnolia customer, a portion of the goods were shipped prepetition, but received by Magnolia postpetition.

Some "Tricks" in CCI's Tool Bag to Get Paid

Traditionally, a vendor whose customer filed Chapter 11 would submit a proof of claim, perhaps serve on the credi-

(*Continued on page 5*)

CONTENTS

Using all of your "tricks" to be paid now and in full, when your customer files bankruptcy	1
Delivery of unpaid product after receipt of preferential transfer may not always qualify as new value	1
China's new bankruptcy law and its effect on international creditors	2
Preference Defense: New challenges facing creditors	2
Court finds that an executory contract, undisclosed in a chapter 11 proceeding, survives the bankruptcy and is enforceable	3
Dealing with your fraudulent customer: Getting paid from your "shadow" debtor	3
Voice mail requesting payment violates the automatic stay—and warrants punitive damages	4

DELIVERY OF UNPAID PRODUCT AFTER RECEIPT OF PREFERENTIAL TRANSFER MAY NOT ALWAYS QUALIFY AS NEW VALUE

Bradley Blakeley
bblakeley@bandblaw.com

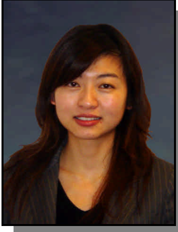
The silver lining to having an unpaid balance upon a bankruptcy filing is that the vendor usually has at least some new value defense to a preference demand. However, as the Court of Appeals for the Seventh Circuit recently determined, that is not always the case, even when the unpaid is delivered after receipt of the preferential transfer.

In *In re Globe Building Materials, Inc.*, the Chapter 7 debtor had a contract with an equipment supplier, which consisted of a unified multi-million dollar contract for delivery of a single complex equipment manufacturing line. The line used a number of component machines which resulted in an overall machine suitable for making the debtor's product. The debtor was to pay the vendor in stages according to a schedule set forth in the contract, and the payment obligation was not tied to the vendor's delivery of any specific system components. Instead, the contract obligated the vendor to deliver parts as they became available. Except for the final payment of the last 10% and final delivery, the payment schedule and delivery schedule were not coordinated, and no payments were tied to specific deliveries.

The alleged preferential transfer was for $419,891.08, which represented approximately 10% of the contract price of

(*Continued on page 9*)

CHINA'S NEW BANKRUPTCY LAW AND ITS EFFECT ON INTERNATIONAL CREDITORS



Shirley Chen
schen@bandblaw.com

In keeping up with its remarkable economic growth for the past few years, China has recently enacted a new Enterprises Bankruptcy Law of the People's Republic of China, effective on June 1, 2007. The new law took twelve years in the making and replaces an existing statute formulated in 1986.

The old law was only applicable to state-owned enterprises, allowing only their government supervisor to put the state-owned companies into bankruptcy. First claim of any remaining assets belonged to the workers. There were no specific provisions for private companies and defaults were worked out in the light of conflicting provisions. The old law has long been criticized for not giving creditors enough protection and allowing workers to be paid first.

The new law includes private companies as well as state-owned enterprises for the first time. It also applies to foreign companies and to Chinese businesses. However, one of the shortcomings is the lack of provision for personal bankruptcy, as it does not apply to individuals. The most important difference between China's new and old bankruptcy laws is that the new law gives secured claims priority over employee, tax, and general claims. Unlike the old law which gave workers first claim to the debtor's assets, the new law allows employee claims to take precedence only over unsecured creditors.

Furthermore, the new law accounts for the extraterritorial effect of Chinese bankruptcy judgments and permits enforcement of foreign judgments from countries that act reciprocally towards Chinese judgment. Creditors with foreign judgments against a bankrupt Chinese company may collect on that judgment in the Chinese bankruptcy court. The new law is also designed to extend to Chinese companies' assets overseas, as long as courts in a host country accept the Chinese ruling.

Some of foreign companies have their actual business assets in China, but have retained their headquarters in Hong Kong or Taiwan as to enjoy a more predictable legal regime. In the past, it was safe to assume that corporate distress could be handled outside China when foreign investors were involved. With its new bankruptcy law, China has asserted jurisdiction over who controls company assets. This could increase state influence.

In addition, the new law permits a single creditor to initiate an involuntary bankruptcy proceeding. The law allows a creditor to initiate the proceeding, and such proceeding can be initiated against any legal entity.

The new bankruptcy law also gives the People's Court the authority to nullify business transactions up to one year before a bankruptcy declaration. The provisions were designed to address fraudulent bankruptcies that previously allowed debtors to escape liability by declaring bankruptcy and transfer company assets to third parties without explanation. The new bankruptcy law imposes a duty on company supervisors to preserve property and financial records, as well as to respond to creditors' interrogatories.

(*Continued on page 9*)

FROM THE PUBLISHER:

***The Trade Vendor Quarterly** is published by the law firm of Blakeley & Blakeley LLP and is distributed as a service to clients and other parties interested in creditor issues. This information is not intended to constitute legal advice, nor a substitute for legal advice.*

Blakeley & Blakeley LLP cannot be held responsible for the accuracy of information contained in articles written by guest contributors. Readers' comments and questions are welcome and should be addressed to:

Scott Blakeley
Blakeley & Blakeley LLP,
1000 Quail Street, Suite 200
Newport Beach, California 92660
Telephone: 949-260-0611
Facsimile: 949-260-0613

Visit the firm's web site at www.vendorlaw.com

Guest Column

PREFERENCE DEFENSE: NEW CHALLENGES FACING CREDITORS

Dorman Wood, CEW, CCE
witness4u@msn.com

At its inception, the Bankruptcy Abuse Prevention and Consumer Protection act of 2005 (BAPCPA) was hailed as the most sweeping revision of the bankruptcy law in more than two decades.

While the majority of the revisions under BPACPA were aimed at individual bankruptcy reform, several touched on commercial bankruptcy reform.

One such revision was to §547(c)(2), which is commonly referred to as a creditor's 'ordinary course of business defense' to a preference suit brought by a trustee, unsecured trade creditors committee or in some cases, a plan administrator. A creditor's ordinary course of business defense' pre-BAPCPA was required to meet a three-prong test to show that a payment received within the 90-day period prior to (and including) the bankruptcy petition date, was: 1) made upon a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and transferee, 2) made in the ordinary course of business or financial affairs of the parties, *and* 3) made according to ordinary business terms. Prongs 1 and 2 were referred to as the "subjective test" of the parties' dealings. Prong 3 was referred to as the "objective test" of the standards observed in the relevant industry.

BAPCPA revision of §547(c)(2) was initially believed to lessen the creditor's burden, as it replaces the conjunctive "*and*" after prong 2 with "or." This revision is interpreted as giving the creditor the option of meeting the "subjective test" of the dealings between the parties, or the "objective test" of the standards observed within the relevant industry in their defense of a preference action. The matter is not as clear-cut as one may initially think after reading the revisions.

As seen in In re National Gas Distributors, LLC, 2006 WL 2135557 (Bankr. E.D.N. C.), the bankruptcy court (Eastern District of North Carolina) ruled that while the creditor only needed to establish one prong of the or-

(*Continued on page 7*)

COURT FINDS THAT AN EXECUTORY CONTRACT, UNDISCLOSED IN A CHAPTER 11 PROCEEDING, SURVIVES THE BANKRUPTCY AND IS ENFORCEABLE

Ronald Clifford
rclifford@bandblaw.com

In a stance of permanence, the United States Bankruptcy Appellate Panel ("Panel") of the Ninth Circuit, this year, confirmed that the Bankruptcy Courts will conform to some of the practices courts have used since the nineteenth century. In *Diamond Z Trailer, Inc. v. JZ, LLC* (*In re JZ, LLC*), No. 07-1011 (9th Cir. B.A.P., June 18, 2007), the Panel decided that the concepts of "ride through" and discretionary judicial estoppel are alive and well in bankruptcy law. Businesses are placed on notice in this case to deal equitably with the courts as well as other businesses.

This case involved an executory contract in which JZ, LLC ("JZ") gave Diamond Z Trailer, Inc. ("Diamond") an exclusive license to manufacture, promote, and sell a certain grinding tool. This executory contract also included a non-competition clause, which prohibited Diamond from manufacturing or selling any other tool of the type the license was based on. Not long after the executory contract was signed, and Diamond began to sell and produce JZ's tool, JZ declared itself bankrupt under chapter 11. In those bankruptcy proceedings, JZ never disclosed the license it had with Diamond. Diamond also never disclosed the contract although it was aware of the bankruptcy proceedings. Soon after the chapter 11 plan was confirmed, Diamond, in violation of the executory contract, began producing a competing tool to JZ's. JZ sued to enforce the contract, and Diamond argued that JZ was judicially estopped from doing such, had no standing to bring such a claim, that this executory contract did not ride through the bankruptcy, and that the state court cause of action remains property of the bankruptcy estate. The Panel ruled in favor of allowing JZ to move forward with the claim.

Judicial estoppel prevents a party from contradicting previous declarations made during the same or a later proceeding if the change in position would adversely affect the proceeding or constitute a fraud on the court. Chapter 11 requires the debtor to file, among other things, the existence of executory contracts. Diamond argued, and maybe correctly, that non-disclosure of the executory contract in the chapter 11 filing should prevent suing for breach of that agreement in a later court hearing. However, the key here is that judicial estoppel is applied at the discretion of the court applying estoppel, and the Panel held that there was no abuse of this discretion in this case.

The court also denied application of Diamond's theory that JZ was barred from bringing suit because the cause of action accrued before the bankruptcy was filed, and therefore is property of the estate under chapter 11. The Panel, applying the 1898 concept of a "ride through," explained that rejection or acceptance of an executory contract in a chapter 11 plan is permissive, not mandatory. The Panel held that if an executory contract is not assumed under the chapter 11 plan, it is presumed rejected, and so it survives the bankruptcy as a standing contract between the parties. More simply put, the failure to include the executory contract in the chapter 11 plan allowed the agreement to ride through the bankruptcy to enable enforcement of it by JZ.

The Panel lastly decided that the undisclosed executory contract was property of JZ under the Bankruptcy Code section 1141(b) concept of vesting. Under section 1141(b), property of a bankrupt estate vests in the debtor after confirmation of the chapter 11 plan. The estate property includes disclosed and undisclosed assets. Even though the executory contract was undisclosed, it remained the property of JZ after the chapter 11 plan was confirmed. The Panel however did suggest that equity could bar the prosecution of undisclosed assets, such as the breach of an executory contract, by a debtor. The Panel, citing *Hay v. First Interstate Bank of Kalispell*, 978 F.2d 555, 557 (9th Cir. 1992), held that an undisclosed asset may be a sufficiently material part of a chapter 11 plan that the court could in good conscience permit the debtor to prosecute it in subsequent litigation. Here, equity did not prevent 1141(b) vesting because no creditors were harmed, first, and second, Diamond itself did not have clean hands in the matter as it did not disclose the executory contract even though it was aware of the bankruptcy at hand.

(Continued on page 9)

DEALING WITH YOUR FRAUDULENT CUSTOMER: GETTING PAID FROM YOUR "SHADOW" DEBTOR

Scott Blakeley
seb@bandblaw.com

A frustrating aspect of a credit executive's job is being ensnared in a customer's planned insolvency. A planned insolvency is a fraud on vendors, where the insiders attempt to obtain the vendor's product or service for free. In one variation of the planned insolvency, a long-standing customer with a consistent payment pattern may run into financial difficulty. In an effort to preserve value for the customer's insiders, the customer may set up a separate company and divert the value from the existing company to the newly formed company, sometimes referred to as a "shadow company" or "shadow debtor." The shadow debtor may sound like a title from a fantasy summer movie, but the credit risk is real.

This is the first of two parts in dealing with the fraudulent customer. In this first part, I discuss what is shadow company fraud, the risk of selling to a customer that has created the shadow company and a recent case that sets out a vendor's rights and causes of action to collect when ensnared in a shadow company fraud, including whether the fraudulent conduct may also be prosecuted on a criminal basis. The second part of this article will discuss a vendor's due diligence and red flags that may indicate a fraudulent transaction may be in the works.

Shadow Company Fraud

Shadow company fraud can take a variety of forms. A common setting is where the insiders of a corporate customer that may anticipate financial difficulty in the near future, or is being pursued by a creditor with a delinquent account, may look to preserve the value of that customer for themselves by shifting the value to a newly formed company. In this setting, the value of the customer, be it in the form of future orders and contracts, and even existing assets such as inventory and accounts receivable, may be gradually transferred to the new company, the shadow company. Alter-

(Continued on page 8)

VOICE MAIL REQUESTING PAYMENT VIOLATES THE AUTOMATIC STAY—AND WARRANTS PUNITIVE DAMAGES

Scott Blakeley
seb@bandblaw.com

You receive notice that your long term customer, a sole proprietor, that you have provided product on credit has filed for Chapter 11 or Chapter 13 bankruptcy. The bankruptcy filing leaves you with a prepetition unsecured claim. You had a long trade relationship with the debtor and routinely follow up delinquent invoices with reminder phone calls. The phone calls generally worked in getting the invoices paid.

A credit professional is well aware that with a bankruptcy filing, whether a Chapter 7, 11 or 13 bankruptcy petition, whether an individual, partnership, corporation or LLC have filed, all collection efforts must immediately cease because of the automatic stay. But does your calling the debtor regarding your prepetition debt constitute a violation of the Bankruptcy Code's automatic stay, especially when you have a continuing trade relationship with the debtor postbankruptcy? What if you leave a voice mail that you may turn the delinquent account over to the local district attorney to investigate any criminal wrongdoing violate the automatic stay, and even lead to punitive damages? In a recent bankruptcy case, *In re Hodge,* the court found the creditor had violated the automatic stay and awarded sanctions.

Creditor's Voice Mail Demanding Payment

In *Hodge*, a creditor held an unsecured claim against the debtor prebankruptcy. The debtor filed for Chapter 13 bankruptcy. The creditor received written notice from the debtor's counsel on the date of the bankruptcy filing that the debtor had filed and that the automatic stay was in effect.

After receiving the letter from the debtor, the creditor left a voice mail demanding the debtor repay the prepetition debt. The creditor also suggested that she had spoken with the local district attorney, and threatened the debtor with arrest and criminal prosecution if the debt was not repaid. The debtor claimed that upon hearing the voice mail and fearing that she would be arrested which would result in the loss of her job and children, the debtor fled her house.

Debtor Claims Damages For Violation Of Stay

The debtor contended that the creditor willfully violated the automatic stay by leaving the voice mail after knowing of the bankruptcy filing, thereby attempting to collect on its prepetition debt. Because the debtor was an individual, the debtor requested that the bankruptcy court assess actual damages, including attorneys' fees and punitive damages against the creditor.

The Automatic Stay: Anything Worth Doing Is Stayed

The automatic stay is an injunction which automatically and immediately goes into effect as soon as a bankruptcy case is filed, whether the bankruptcy filing is one under Chapter 7, 11 or 13, and whether the case is commenced as an involuntary bankruptcy. The stay is automatic in the sense that it arises automatically upon filing the bankruptcy case by operation of law, without the bankruptcy court having to enter an order stating that it exists. The stay is in effect even where the creditor has not been given notice that the bankruptcy case has been filed.

The automatic stay prohibits any creditor from taking action against the property of the estate and against the debtor, unless relief from stay is obtained. For example, a vendor is barred from seeking or levying writs of attachments or garnishments, and also stays the vendor from a judicial lien against the debtor, but has not yet levied on any property. The stay also enjoins secured creditors from repossessing or selling collateral.

The purpose of the automatic stay is to give the debtor breathing room, and to protect creditors from each other by preserving the bankruptcy estate intact until property can be distributed according to the bankruptcy priority scheme and allow orderly administration of the case. The scope of the automatic stay is so broad that any action to collect is probably stayed. The debtor cannot modify the stay without the bankruptcy court modifying the stay and creditors having the opportunity to comment.

Damages are assessed against a creditor only where it is shown that the creditor had notice or knowledge of the bankruptcy filing. Where there is a willful violation of the stay, the court will award a debtor actual damages, including a debtor's attorney's fees and costs for enforcing the violation. The court may also award punitive damages to punish the creditor.

Creditor's Voice Mail Violates the Stay and Merits Punitive Damages

As a starting point, the bankruptcy court found that creditor, through its representative, was a ware of the debtor's bankruptcy and the automatic stay when the voice mail was left. The court observed that the phone call and voice mail was an act to collect a prepetition debt. Therefore, the creditor, through its employee, willfully violated the automatic stay. For this violation of the automatic stay, the debtor sought damages in the form of attorney's fees of $4,000 in responding to the voice mail. The court agreed and found the attorney's fees were necessary to protect the debtor's interests.

The court then considered whether punitive damages should be awarded to the debtor for the creditor's violation of the automatic stay. The court found that using any standard, punitive damages were appropriate given the creditor's threat to have the debtor arrested and criminally prosecuted was wrongful. The court observed that under the state's bad check laws, the debtor could not be prosecuted criminally. Thus, the creditor's action was malicious and vindictive, as the language in the voice mail conveyed a getting even with the debtor, through arrest, for failing to repay the debt. The creditor's conduct was motivated to coerce the debtor into paying the debt outside of the bankruptcy proceeding.

Communicating with the Debtor Post-bankruptcy

The *Hodge* court reminds a credit executive that attempts to communicate with the debtor postbankruptcy regarding your prepetition claim may be viewed as pressuring the debtor to pay the prepetition claim, thereby violating the automatic stay. Although it is understandable to be frustrated with a debtor attempting to walk from your prepetition debt through a bankruptcy filing, the *Hodge* court highlights the risk of a creditor attempting to even the score with a false threat of criminal prosecution, especially in an effort to force payment on a prepetition debt. Remember, bankruptcy courts regard the automatic stay as a fundamental protection for the debtor and a primary reason for a debtor filing bankruptcy. A vendor that knowingly violates the automatic stay by pressuring the debtor to pay prepetition delinquent account risks sanctions by a bankruptcy court.

USING ALL OF YOUR "TRICKS" TO BE PAID NOW, AND IN FULL, WHEN YOUR CUSTOMER FILES BANKRUPTCY

(Continued from page 1)

tors' committee, and press the debtor for a meaningful payment while working collectively with other creditors. Because of the automatic stay, a vendor holding an unsecured claim was limited as to their options to collect on the prepetition claim. The general rule has been that the vendor would wait (patience was key) until a chapter 11 plan was confirmed and the vendor would receive a percentage distribution with its class of creditors.

Fortunately for vendors, more recently bankruptcy courts are often granting certain motions that give certain vendors preferred treatment, coupled with greater vendor protections under the Bankruptcy Reform Act, and protections under a state's lien law resulting in more vendors receiving sizable distributions on their claims, and perhaps on waiting until a plan in confirmed, especially those vendors with a substantial trade relationship and recent shipments to the customer. Some of the vendor "tricks" that may reward the vendor with near immediate payment are considered.

The First Customer's Bankruptcy Filing

CCI's customer Deltak is in the business of manufacturing custom boilers that are used as component parts to refinereies and process plan applications, with operations throughout the world. Deltak was part of a corporate family with sales in the billions. Notwithstanding its corporate headquarters in Oklahoma, Deltak filed its chapter 11 in Delaware, a common chapter 11 destination for large corporate debtors. Deltak's bankruptcy attorneys were headed up out of Miami and Delaware. The office of the U.S. Trustee appointed a creditors' committee as well as an equity committee. CCI submitted its request to serve on the creditors' committee but the US Trustee selected creditors holding larger unsecured claims.

One of the first steps in the bankruptcy filing of the corporate parent was to file a motion with the bankruptcy court to wind down the operations of Deltak's business. In this wind down setting, CCI's strategy of looking for ways to get immediately paid on its prepetition debt became more complicated as Deltak would not be an ongoing operation and therefore the continuing need for CCI product, as well as payment for the prepetition product.

Payment of Prepetition Claim

Prior to the bankruptcy, CCI had shipped its product to Deltak on open account. At the time of the bankruptcy filing, CCI had a low six figure unsecured claim. CCI's past experience with chapter 11 was common to most vendors: having to wait a significant time for a speculative percentage payment on its prepetition claims. Hoping that secured creditors or professional does not take all the value of the debtor. Further, CCI had been a target of preference actions with customers filing bankruptcy. Given this, CCI had to immediately look to its bag of "tricks" in hopes of early payment on its prepetition claim, as well as eliminating its preference risk.

Reclamation

CCI's first "trick" to accelerate payment on its prepetition claim was to seek to convert a majority of its claim from a non-priority to a priority claim. A key legal principle under the Bankruptcy Code is that a priority claim is paid in full prior to non-priority, unsecured claims. As noted, CCI had to balance any "trick" for early payment with the effect of the automatic stay on such request.

A significant portion of CCI's debt was through shipments received by Deltak within 45 days of the bankruptcy filing, and of the amount received within 45 days, a large percentage of the shipments were received by Deltak within 20 days of the bankruptcy filing. CCI overnighted and faxed CCI's reclamation demand to Deltak within 48 hours of the bankruptcy filing. As Deltak refused to respond to the reclamation demand letter, CCI then filed a motion with the bankruptcy court requesting allowance of the goods that CCI had shipped and Deltak received within 45 days, including those goods Deltak received 20 days prior to the bankruptcy filing, the so-called 503(b)(9) motion, including immediate payment for those goods. Deltak agreed to give CCI an administrative claim for the invoice value of the goods received within 20 days. However, Deltak would not agree to immediate payment of the administrative claim.

Lien Rights

Another "trick" CCI used to prompt early payment was to enforce its state law lien rights. A mechanics lien is one where a subcontractor furnishes labor or materials to real estate and may record a claim for lien against the owner. Given the variety of deadlines with respective state lien notice requirements, where one project was pending, as well as those in Canada where another project was pending, CCI had to quickly research California's notice requirements so as not miss the notice deadlines. CCI recorded its stop notices and lien notices. With the bankruptcy filings, CCI could not foreclose on the liens against Deltak, but could against the owner of the project, who was not in bankruptcy. CCI filed an action to foreclose against the project owner. This prompted a response from the project owner who contacted Deltak regarding payment of CCI's delinquent account.

Assignment of Operating Agreement

In winding down its operations, Deltak requested that the bankruptcy court authorize it to sell and assign its operating agreement with the power plant to the owner of the plant. The new operator was welcome news to vendors as it provided an opportunity for early payment. CCI's "trick" was to immediately contact the proposed buyer about assuming the CCI P.O. After negotiations, the buyer agreed. Under the assumption and assignment agreement, the buyer paid CCI's prepetition debt, and CCI agreed to release its lien rights.

Assumption of P.O.

The significance of the "trick" of CCI's P.O.'s being assumed was that the prepetition delinquent account needed to be "cured" or paid. The new owner of the project agreed to assume CCI's prepetition P. O's.

The Critical Vendor Doctrine

Another "trick" considered by CCI upon learning of the bankruptcy filing was to be considered by Deltak as a critical vendor. Under this doctrine, a debtor may pay certain prepetition claims, with bankruptcy court approval, usually at the start of the bankruptcy case where it can be established that payment of those claims will help to stabilize the debtor's business without significantly harming any party. The payment

(Continued on page 6)

USING ALL OF YOUR "TRICKS" TO BE PAID NOW, AND IN FULL, WHEN YOUR CUSTOMER FILES BANKRUPTCY

(Continued from page 5)

of these claims is to induce vendors to continue supplying key goods and services post-bankruptcy on credit, which will enable a debtor to rehabilitate its finances. After analyzing postpetition credit risk, CCI requested being selected as a critical vendor. However, Deltak did not file a motion with the bankruptcy court requesting critical vendor treatment, but rather looked to assign the operating agreement, and allow the buyer assuming the operating agreement to select which vendors that would have their claims paid.

Goodbye to Preference Risk

During the 90 days prior to the bankruptcy petition, Deltak had paid CCI approximately $100k+. CCI was concerned that a part, or all, of the payments would be challenged as a preference. Given this, CCI requested Deltak that its prepetition P.O. be assumed and assigned. The assumption of the P.O. would allow CCI to generally avoid preference exposure based on bankruptcy court decisions. Further, CCI's mechanic's lien rights could also possibly provide a preference defense.

Selling Post-Bankruptcy

Pre-bankruptcy, CCI would specially manufacture goods for Deltak. CCI did not have an outputs contract or distribution agreement with Deltak, but rather sold P.O by P.O. The assumption of CCI's P.O., and resulting payment on the prepetition debt, did not come with a condition that CCI ship postpetition, nor did the Deltak's agreement to allow CCI's reclamation claim as an administrative claim require that CCI provide credit terms postpetition.

The Second Customer's Bankruptcy Filing

Magnolia's business was part of a complex family of partnerships engaged in generating and selling wholesale electric produced at their plant. Notwithstanding its corporate headquarters is located in Alabama, Magnolia filed its Chapter 11 in New York. Like Deltak's filing in Delaware, New York is a popular chapter 11 filing location for large corporate debtors as well. Magnolia's bankruptcy attorneys were headed up out of New York. Like the Deltak case, the U.S. Trustee appointed a creditor's committee as well as an equity committee. CCI elected not to submit its request to serve from on the creditors' committee as it was devoting its efforts on the Deltak case also.

Goods Received Postpetition

Another "trick" CCI used to prompt early payment was to examine the timing of its shipments. In the Magnolia bankruptcy, CCI had shipped a portion of its goods just prior to the bankruptcy filing, but Magnolia did not receive postpetition. CCI contacted Magnolia regarding the immediate payment of these goods, given that they were received postpetion. Magnolia filed a motion with the bankruptcy court to grant administrative status for goods and services that were delivered postpetition, but ordered prepetition. The bankruptcy court approved the motion, and Magnolia paid CCI the invoice for the goods Magnolia had ordered prepetition and received postpetition.

Purchase of Claim

An institutional investor offered to purchase substantially all of Magnolia's assets and pay off the unsecured creditors claims. The bankruptcy court approved Magnolia's motion for the sale of assets, which included a provision for payment in full of unsecured creditors' claims. CCI filed a proof of claim and CCI was paid within 90 days. While CCI did not have to use a "trick" to get paid through the sale motion, it did work closely with Magnolia and the buyer regarding assuming the debt.

No "Claw back" Provision

Some debtors and creditors committees insist that the vendor which has its prepetition claim paid postpetition by bankruptcy court order agree to a "claw back" provision that is triggered should the vendor stop shipping postpetition. Under a typical clawback provision, a vendor may be required to provide product or service on credit for, say, a year, so that the bankruptcy estate may receive the profit on the sale of the vendor's product or service to make up for the early payment of the claim in full. CCI was not required to enter into a clawback agreement.

Working with the Committees

Two official committees had been appointed in both bankruptcy cases, an official creditors' committee and an official equity committee. In both bankruptcy cases, the committees were closely involved in the process that led to the payment of CCI's claims. While the committees did not oppose any of CCI's "tricks", they did have standing to do so and their attorneys were paid by the debtors.

Persuading the Bankruptcy Court

In both bankruptcy cases, neither the debtors, committees and secured creditors opposed CCI's "tricks" for early payment. However, the bankruptcy courts still reviewed all of the requests with an independent eye. Fortunately, the bankruptcy courts approved all of the requests.

The "Tricks" Get CCI Paid

CCI was not content to sit back and hope that payment would eventually be forthcoming when its customers filed Chapter 11. Being vigilant and impatient, applying a vendor's "tricks," CCI was able to be paid promptly, and in full, notwithstanding the Chapter 11 filings.

---

i. Scott Blakeley, of Blakeley & Blakeley LLP, practices creditors' rights and bankruptcy law. His e-mail is seb@bandblaw.com.

ii. Robert Meza is the Global Collections Manager for CCI. His email is RMeza@ccivalve.com.

Guest Column

PREFERENCE DEFENSE: NEW CHALLENGES FACING CREDITORS

(Continued from page 2)

dinary business defense under the revised statute, it required the court to consider the ordinary business terms of both debtor's industry and creditor's industry.

The National Gas decision is but one of a limited number that have handed down in post-BAPCPA preference suits. Based on a nonscientific survey of bankruptcy attorneys, it appears too early to determine how the courts will view creditor's ordinary course defenses in cases yet to be tried.

It does appear however, that plaintiff's (debtor's) attorneys are becoming more creative in their efforts to counter creditor's ordinary course defenses. In a recent 5th Circuit (Western District of Texas) preference suit, plaintiff's attorney claimed that defendant (creditor) had not met the burden of the two prongs of ordinary course between the parties, or within their industry. A few of the reasons stated in plaintiff's motion to exclude various reports, testimony and evidence were as follows: 1) creditor did not follow its own written credit policy and procedures; 2) the manner in which debt was incurred was not proven; 3) the manner in which debt was incurred by plaintiff's competitors was not proven; 4) creditor did not prove the manner in which its competitors dealt with plaintiff; 6) creditor did not prove that its collection practices were according to industry standards, and, 7) creditor did not have a written policy for document retention or destruction or follow any apparent routine for document retention or destruction.

A settlement of this case negated the scheduled trial, therefore, we will never know who might have prevailed at trial. However, the points listed above could be used by creditors in general for the purpose of reviewing and improving their internal policies and procedures; becoming more aware of the business practices of their competitors and, if not already in place, to develop and implement a written policy and procedure for the retention or destruction of documents.

If polled, the majority of credit executives will likely state that they have credit policies and procedures in place at their respective companies. However, if asked whether their policies and procedures are applied equally and fairly to all customers, the same credit executives may not answer yes in the majority. Further, if the same credit executives are asked when the last time their policies and procedures were reviewed and updated, they may not be able to give a definitive answer. The primary purpose of credit policies and procedures is to provide a basis for the manner in which the daily functions of the credit department are carried out, as well as the application of the policies and procedures to customers. The policy and procedures must be reviewed on a regular basis and updated if needed in order to keep pace with any changes in the business environment in which the creditor operates. In an ordinary course of business defense in a preference suit, the creditor must provide evidence that its credit policies and procedures are similar to those of its competitors and/or like companies within their industry and, that the policies and procedures are applied equally and fairly to all of its customers.

"On December 1, 2006, the Federal Rules of Civil Procedures were amended to address court procedures for disclosing electronic information during the discovery phase of litigation. The new court rules begin to apply to a company when litigation is "reasonably anticipated." At that point, a company must put a "litigation hold" on its electronic and other records that may be discoverable in litigation. Companies that take this step will be protected against court sanctions, so long as they take reasonable steps to protect and preserve information."

The Federal Rules of Civil Procedures are considered to apply to bankruptcy proceedings and therefore, apply to discovery (also referred to as production) of documents in a preference suit. Motions for discovery or production filed by counsel for both plaintiff and defendant are generally far-reaching and include, but are not limited to all documents or records pertaining to the business relationship between the parties. Such documents or records can include emails – internal and external; accounts receivable records – aging reports, cash application and check copies; lock box records; invoice copies; collection notes – hard copy or electronic; contracts or distribution or purchase agreements; purchase orders; shipping records; notes from telephone calls; other forms of correspondence, and policies and procedures to name a few. Documents or records described may have been stored electronically – on servers, disc drives – internal or external, laptops, PDA, or in hard copy form.

Creditors who may not have a written policy or procedure in place governing the retention and or destruction of corporate documents are encouraged to develop and implement one. Those who have already have such a policy and procedure in place should review it and revise as needed to conform to recent court decisions. Remember, preference suits may be filed any time within two years following the bankruptcy petition date. The time to start gathering documents to aid in a preference defense is not when a notice of such preference action is received.

Other examples of such creativity were apparent in a preference suit filed in the 8th Circuit (Eastern District of Missouri), in which plaintiff's attorney listed the following reasons had not met the burden of proof for an ordinary course defense: 1) defendant's use of a lock box for collection of customer payments was not ordinary; 2) defendant's observance of customers' instructions for payment application [remittance advice] was not ordinary; 3) accuracy and validity of documents reprinted from defendant's ERP system were unreliable due to a system conversion; 4) due to system conversion, defendant could reprint documents that were identical to the originals sent to plaintiff prior to the conversion, and 5) weekly phone calls by defendant to plaintiff to follow up on payment schedules was not ordinary.

While credit executives, and perhaps some bankruptcy professionals may be left scratching their heads over some of the above listed points, they are a few examples of what creditors may be required to prepare for in defending a preference suit. Creditors may also use them as reminders of areas of their business and credit department operations that should be reviewed and revised if necessary with an eye toward preference defense.

While the intent in revising §547(c)(2) may have been to ease the ordinary course of business defense burden of proof for creditors, many bankruptcy professionals believe it still too early to how the courts will rule in the current cases in progress, as well as those filed in the future. In re National Gas Distributors, LLC, 2006 WL 2135557 (Bankr. E.D.N.C.), not withstanding, it still appears too early to label the "ordinary course" revisions as "creditor friendly."

Mr. Dorman Wood is president of Dorman Wood Associates, Inc. and advises creditors as to their preference defenses, including serving as an expert witness in such actions.

His email address is witness4u@msn.com and his website is www.witness4u.com

DEALING WITH YOUR FRAUDULENT CUSTOMER: GETTING PAID FROM YOUR "SHADOW" DEBTOR

(Continued from page 3)

natively, the insiders may simply transfer all of the assets to the shadow company for little or new value. In each setting, the former customer is abandoned by the insiders, whether through an out-of-court liquidation or bankruptcy, and the shadow company operates free from the former vendors' debts. Vendors of the customer do not have any immediate assets for payment.

Notwithstanding this seemingly bleak picture for payment, a vendor may have a number options that may lead to payment of the delinquent account. In *In re Aqua Clear Technologies, Inc.*, a bankruptcy court recently considered the rights of vendors ensnared in a shadow company to be paid through a number of sources, including the insiders of the former customer and the shadow company. The *Aqua Clear* decision is considered.

Is Shadow Company Bona Fide?

Background

In *Aqua Clear*, a creditor obtained a judgment against its customer (Debtor). Three weeks prior to filing bankruptcy, the Debtor formed another corporation (Shadow Company) to carry out the business of the Debtor. The principal of the Debtor transferred the assets of the debtor to the Shadow Company for little or no value. The Shadow Company used the same phone number of the Debtor and serviced in the same area and almost same customers of the Debtor. The Debtor's customer list was transferred to the Shadow Company. The Debtor then filed bankruptcy seeking to have the creditors barred from collecting from Shadow Company.

Attacking The Shadow Company As A Fraud

In *Aqua Clear*, the bankruptcy trustee, acting on behalf of the unsecured creditors of the Debtor, initiated a lawsuit against the Debtor, its insiders and the Shadow Company to recover the transferred assets.

Conversion Claim

The trustee asserted a conversion claim against the Debtor's insider contending that they had taken the Debtor's property without accounting for it. The court agreed.

Fraudulent Conveyance Claim

The trustee also argued that the Debtor's insiders committed a fraud on creditors. The Court started its analysis by noting that it may presume fraud when a transfer occurs between two corporations controlled by the same officers and directors. The Court considered several factors to determine whether the transfers from the Debtor to the Shadow Company were valid: the transfer to the Shadow Company was an insider; the Debtor retained control of the property transferred after the transfer; the transfer was concealed before being made; the Debtor had been sued or threatened with suit; the Debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred. The *Aqua Clear* Court found that the transfer of the Debtor's assets to the Shadow Company was made with an intention to defraud creditors and therefore avoidable as fraudulent or preferential transfer.

Breach of Fiduciary Claim

Claims were also brought against the Debtor's insiders for breach of fiduciary duty. The elements are: an officer and director must perform his or her corporate duties (1) in good faith; (2) with such care as an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.

The court found the insiders had breached their duty to the Debtor's creditors for transferring assets to the Shadow Company for little or no value. The court also found that by using the Debtor to fund personal expenses, the insiders of the debtor breached their fiduciary duty to creditors.

Alter Ego Claim

The trustee also asserted claims against the Shadow Company under the theory of alter ego. To disregard the corporate entity form and find that one entity is the alter ego of another, three elements must be established: control of the corporation such that it has no independent existence; that the corporate form was used fraudulently; and that the fraudulent use of the form proximately caused the creditor's injury.

The Court noted that the Debtor and the Shadow Company were in the same business, used the same telephone number, and operated from the same address. They serviced the same geographic area and many of the same customers. The Debtor and the Shadow Company also had identical officers and directors.

The Court found that the Shadow Company was simply a continuation of the Debtor's business under a new name, and using the Debtor's assets. Since the Shadow Company used the debtor's assets and was operating in the same area and customers of the Debtor and was controlled by same persons, the Court found that Shadow company was the alter ego of the Debtor and was liable for claims against the Debtor.

Referral For Criminal Investigation

Those that perpetrate Shadow Company fraud may not only be personally liable for the debts of the creditors selling to the Debtor and the Shadow Company, but such fraud may rise to the level of a crime. In *Aqua Clear*, the Court requested the United States Trustee to undertake a review of the matters and to report to the United States Attorney's Office for criminal investigation.

A Vendor's Due Diligence

The *Aqua Clear* Court's ruling is welcome news for a vendor ensnared in a Shadow Company fraud. The decision sets out a road map for a vendor to develop facts that may be helpful in crafting claims against all of the parties participating in the fraud.

However, collecting from parties that have concocted the fraud can be a drawn-out, and, at times, uncertain process. Given this, due diligence at the outset of the credit evaluation stage, coupled with monitoring customers for red flags that may be contemplating a Shadow Company fraud may be key to reducing or eliminating credit loss.

The second part of this article will discuss a vendor's due diligence and red flags that may indicate a fraudulent transaction may be in the works.

CHINA'S NEW BANKRUPTCY LAW AND ITS EFFECT ON INTERNATIONAL CREDITORS

(Continued from page 2)

The new law will not start working until Beijing issues a raft of implementation rules, setting up the criteria and appointment of judges, and in speeding up training and education of judges. Beijing may focus on strengthening the quality of its bankruptcy law professionals in a few select cities, such as Shanghai and Beijing. It will take time for detailed rules and procedural guidelines to be made. Due to China's lack of local experienced insolvency practitioners and judges, it may take some time before the new law can be implemented smoothly and consistently across China.

COURT FINDS THAT AN EXECUTORY CONTRACT, UNDISCLOSED IN A CHAPTER 11 PROCEEDING, SURVIVES THE BANKRUPTCY AND IS ENFORCEABLE

(Continued from page 3)

Overall, this case sets a limited precedence. The Panel seems to limit the holding to narrow sets of facts similar to those present in this case. However, it is important for creditors to remember that equitable actions carry a lot of weight with courts, and should be the mainstay of all transactions. Although JZ did not list this executory contract in its bankruptcy schedules as it was required to do, Diamond Z stood in pari delicto by failing to raise the agreement in a bankruptcy it knew was pending. This case is evidence that courts are willing to dig deep into the past to find law applications that punish inequitable actions.

DELIVERY OF UNPAID PRODUCT AFTER RECEIPT OF PREFERENTIAL TRANSFER MAY NOT ALWAYS QUALIFY AS NEW VALUE

(Continued from page 1)

the equipment line and was supposed to be the second to the last scheduled payment under the contract. After it received the alleged preferential transfer, the vendor completed its production of the equipment line and offered to ship the rest of the equipment. The parties stipulated that the vendor had fulfilled its delivery obligations by making the components available to the debtor even though the debtor never physically took possession of the full line.

The vendor asserted a new value defense to the preference action, and the trustee asserted that the vendor's delivery during the preference period of equipment components that it was obliged to furnish did not constitute new value. The trustee argued, and the court agreed, that Congress intended the definition of "new value" to codify the principle of consideration from contract law. Consideration must be something that the promisor is not already obliged to give to the promisee, that is, something additional or new. The performance of a legal duty owed to a promisor is not consideration.

The court found that the vendor already had an obligation to deliver the portion of the line equipment to the debtor that it delivered to the debtor after it received the transfer, and the debtor already had an obligation to make its scheduled payment on the contract. As a result, both the debtor's obligation to pay and the vendor's obligation to deliver the product were anything but "new" when it made the delivery and finished production. Further, as defined under the Bankruptcy Code, "new value" does not include an obligation substituted for an existing obligation.

The court found that the contract was a unified contract for the delivery of a single complex equipment manufacturing line, and that just because the parties structured both payment and delivery obligations under the contract to extend over a period of time do not transform each payment, or each delivery of goods, into an independent transaction. As a result, neither the product delivered nor the product specially produced did not qualify as new value. On a bright note for vendors, the court recognized that its analysis would have been different if the vendor and the creditor had agreed to an installment contract, and not one single contract for the payment and delivery of the equipment.

KEEPING THE CREDIT AND FINANCIAL PROFESSIONAL INFORMED OF LEGAL DEVELOPMENTS VISIT OUR WEBSITE @
www.bandblaw.com

The Trade Vendor Quarterly is distributed via E-Mail. ***The Trade Vendor Quarterly*** is a free publication prepared by the law firm of Blakeley & Blakeley LLP for clients and friends in the commercial credit and financial community. Please complete the following:

Representative to Receive Newsletter: ______________________________

Company Name: ______________________________

E-Mail Address: ______________________________

Telephone: ______________________________

Facsimile: ______________________________

Mailing Address: ______________________________

____

____

Others to Receive Newsletter: ______________________________

____

Please forward the information via:

E-mail: administrator@bandblaw.com

Fax: (949) 260-0613

Mail: Ms. Karen Sherwood
Blakeley & Blakeley LLP
1000 Quail Street, Suite 200
Newport Beach, California 92660