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THE TRADE VENDOR QUARTERLY

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

GETTING PAID NOW -- AND IN FULL! -- IN BANKRUPTCY: THE NECESSITY DOCTRINE IN ACTION

Scott Blakeley and Bill Weilemann, Packaging Corporation of America [1]

One of the noted effects of Chapter 11 bankruptcy proceedings is that vendors can suffer long delays before receiving payment on their prepetition unsecured claims. These same vendors often find that the distribution on their unsecured claims is far less than the amount owed. Indeed, it is not uncommon for vendors to be paid through a confirmed plan of reorganization with a debtor's stock. Does a vendor in this situation have any recourse?

On occasion a vendor may find that the product or service it provides a Chapter 11 debtor is essential and is key to the debtor's continued operations. The uniqueness of the product or service may give such a vendor leverage in negotiating post-bankruptcy sales. In this situation the debtor may request that the court allow it immediately to pay the vendor's prepetition claim in the first days of the bankruptcy, in exchange for the vendor committing to sell to the debtor post-bankruptcy. This article will discuss how courts allow early payment of certain vendors' pre-bankruptcy unsecured claims in limited situations under the Doctrine of Necessity. Stated simply, the Doctrine of Necessity says that the debtor needs the vendor's product or service in order to reorganize its finances.

The Necessity Doctrine

A fundamental principle of bankruptcy is equal treatment of similarly situated creditors. This is especially true when it comes to payment on creditors' prepetition claims. In bankruptcy, creditors can be paid on their unsecured claims only through a confirmed plan of reorganization or court-authorized liquidation.

The Bankruptcy Code is straightforward that a creditor holding an unsecured, non-priority claim is not to be favored by a debtor, except under very limited circumstances. Courts have carved an exception to this general rule and labeled it the Necessity Doctrine. Under the doctrine, a debtor may pay certain prepetition claims, with court approval, at the commencement 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 of these claims is to induce creditors to continue supplying key goods and services post-bankruptcy, which will enable -- or be necessary for -- a debtor to rehabilitate its finances.

Tenneco recently had occasion to examine the Necessity Doctrine. Tenneco manufactured corrugated containers. Its customer, the Debtor, distributed packaging products. The Debtor also operated two related companies, a plastics manufacturer and printer. The three companies formed one of the largest packaging manufacturers, printers and distributors in the state of California.

Tenneco supplied containers pursuant to the Debtor's purchase orders, shipping the packaging to the Debtor who then distributed the packaging and took a markup on the sale price. Tenneco was the Debtor's largest vendor, and the source of significant revenues.

Notwithstanding the profitable trade relationship with Tenneco, the Debtor was unable to satisfy its secured obligations and, along with its two related companies, was forced to file a chapter 11 petition. The Debtor needed Tenneco's product to continue operations. At the time of the bankruptcy filing, the Debtor had a large backlog of orders for Tenneco to manufacture.

The Debtor claimed it would not survive, if Tenneco severed its business relationship with the Debtor. The loss of Tenneco's product would affect the ability of the Debtor, as well as its two related companies to operate

The Agreement

For Tenneco, the account had been profitable. In order to continue operations, the Debtor was in immediate need of Tenneco's product. Tenneco had certain

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STANDARD FINANCING STATEMENT NOT ENOUGH TO PERFECT INTEREST IN EQUIPMENT

Scott Blakeley

Selling equipment on credit? The Uniform Commercial Code (UCC) requires a vendor take certain steps to protect itself in the event a debtor defaults on a payment contract. This article does not discuss the special perfection requirements of equipment that may be deemed fixtures. Failure by a vendor to comply strictly with the perfection requirements set out by the UCC may result in the unpaid vendor's loss of interest to merchandise it contracted to sell.

In *In re Arctic Air, Inc.*,[1] a vendor sold equipment on credit, and the buyer signed a financing statement -- but not a security agreement. A standard financing statement, standing alone, does not constitute a "security agreement," and the court ruled in this case that the vendor was not a secured creditor.

The Debtor Intends To Grant A Security Interest?

In *Arctic Air*, a vendor sold equipment on credit to a buyer. An invoice identifying the equipment was signed by the buyer's president and controller. The vendor filed a UCC-1 financing statement and attached a list of collateral, as well as invoices for the equipment. But the parties never signed a security agreement.

The debtor failed to pay the vendor, and filed Chapter 11 bankruptcy, which was later converted to Chapter 7. The Chapter 7 trustee announced a public auction of the debtor's assets. The trustee was then notified by the vendor that the vendor had a security interest in certain equipment among the debtor's assets. The vendor alleged that because it had a security interest, it was entitled to proceeds from the sale of the equipment.

The trustee objected to the vendor's secured claim. The trustee's contention was that, without a formal security agreement between the debtor and the vendor, that the vendor did not in fact have a security interest in the equipment. In other words, the vendor's claim was therefore unenforceable, making the vendor just another unsecured creditor.

FROM THE PUBLISHER:

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

Steps To Perfection

What would have made the vendor's claim secured? Article 9 of the Uniform Commercial Code (UCC) governs the perfection and priority of competing creditors on personal property. Personal property is property other than real estate, some fixtures, and certain intangible assets. To have a security interest in personal property, a vendor must go through a multi-step process. The steps can be divided into *creation of a security interest* and *perfection of the security interest.*

Creation of the Security Interest

The three requirements that need to be met in the creation of a security interest are: (1) value must have been given by the vendor, (2) the debtor must have rights in the collateral it offers, and (3) the debtor must have signed a security agreement which contains a description of the collateral.

Traditionally, the security agreement is contained in a separate security instrument. However, some courts have ruled that a separate formal document entitled "security agreement" is not always necessary to satisfy the signed writing requirement. As long as there are documents, the reasoning goes, such as promissory notes or financing statements, the UCC's requirement for a security interest may be satisfied. These documents, examined collectively, must (1) adequately describe the collateral, (2) carry the signature of the debtor, and (3) establish that a security interest was agreed upon by both parties. In this way, a security agreement may be found through a collective examination of various documents, none of which could, standing alone, be deemed a security agreement.

Perfection of the Security Interest

A vendor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the collateral. The main purpose in filing a financing statement is to guarantee that any third parties will have been notified of existing security interests in the collateral. The filing vendor thus takes priority over other creditors and has the right to take possession of and sell the collateral if the debtor defaults.

A Security Interest Describing Collateral?

The *Arctic Air* court sustained the trustee's objection to the vendor's alleged secured claim. The court found no evidence of the debtor's intent to grant a security interest to the vendor. The court stated that a UCC-1 financing statement containing a description of the property, together with invoices from the vendor to the debtor, do not create a valid security interest:

"No separate written agreement

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REWRITING THE PREFERENCE LAWS: PROPOSAL MADE TO NATIONAL BANKRUPTCY REVIEW COMMISSION

Scott Blakeley

A fundamental principle of bankruptcy law is equality of distribution of a debtor's assets to creditors. This principle disfavors transfers by a debtor that benefit one creditor at the expense of other creditors. The bankruptcy preference laws are central to this principle and they are the primary instrument in achieving equality of distribution. Over the last decade the preference laws have been scrutinized by a number of groups asking whether the laws are achieving the fundamental purpose for which Congress intended.

Two years ago the American Bankruptcy Institute appointed the Preference Task Force to examine this issue. The Preference Task Force comprised a group of credit executives, attorneys and bankers from around the country, and was chaired by Joseph Bodoff of Hinckley, Allen & Snyder in Boston (the author was a member of the Task Force). The Preference Task Force prepared detailed questionnaires for credit executives, bankruptcy trustees and lawyers and surveyed their preference experience and whether the preference laws were achieving Congress' fundamental goal of equality of distribution for creditors.

Responses to the questionnaires provided by credit executives were consistent and straightforward: bankruptcy preference laws are simply unfair to the trade, and prosecution of preference lawsuits usually result in only filling the pockets of the professionals that pursue the actions. The exception of the ineffectiveness of the preference laws from the trade's perspective was the provision of preference claims against a debtor's insiders.

The Preference Task Force published its findings gathered over the last two years and recommendations for change in a Report authored by Professor Charles Tabb of the University of Illinois School of Law. The Task Force's Report was circulated to members of the Bankruptcy Review Commission and members of Congress. Members of the Task Force reported to the Bankruptcy Review Commission that the preference laws were not working, especially from the perspective of trade creditors. In part as a result of the efforts of the Preference Task Force, a working group comprised of members of the Bankruptcy Review Commission has recommended to the full Review Commission to consider rewriting the preference laws. While the Proposal does not adopt abolishing the preference laws (which the trade would favor), it does address certain of the concerns of the trade.

What Is A Preference?

The Bankruptcy Code vests the 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 power to avoid preferential transfers is one of the most powerful weapons a trustee has. The Bankruptcy Code defines a preference expansively to include nearly every payment by an insolvent debtor 90 days prior to bankruptcy. The purpose of the preference provision is two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

The Bankruptcy Review Commission

The Bankruptcy Reform Act of 1994, wherein Congress overhauled the Bankruptcy Code, created a nine-member bankruptcy commission to make recommendations on whether further reform of the bankruptcy laws are necessary. The Commission has been soliciting views, including holding hearings, as to the operation of the bankruptcy system. The Commission is considering the effectiveness of the preference laws and whether they should be rewritten. Below is a summary of the memorandum to the full Commission on reform of the preference law.

Rewriting the Preference Laws

Members of the Bankruptcy Review Commission observed the shortcoming of the preference laws:

> "[A]lthough the theory and substance of the preference powers are sound, the practice of preference recovery is somewhat flawed. The argument is that section 547 leads to abusive preference recovery suits by bankruptcy trustees who bring actions indiscriminately, without properly analyzing the creditor's available defenses, and to obtain settlements by creditors because of the litigation costs associated with defending these actions. . . a trustee (or in rare instances, a debtor in possession) sends out a blanket complaint to virtually every creditor, particularly trade creditors, who received any payment within ninety days of the petition date. The trustee would have done little to no prior investigation other than to review the debtor's check register and would have made no effort to determine whether the creditors have any valid defenses. Given the small amount of money at stake, it is rarely cost-effective for the creditor to contest the action, especially if the creditor is located in another state. As a result, those creditors are led to settle the action regardless of its merits."

The Proposal to the full Commission to reform the preference laws contains three points.

Minimum Threshold to Sue for a Preference

Receiving a preference complaint by a trustee for under $5,000 has a special set of problems for credit executives. To employ counsel and defend the preference lawsuit is not cost effective, even if the credit

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

Scott E. Blakeley [1]

Editor's note: This is part two of a two part article. The first part appeared in the Spring edition of the newsletter.

These courts also articulate that the policy objectives supporting the subsequent advance rule are better met when the paid subsequent advance is not subject to avoidance. In *IRFM*, the Ninth Circuit rejected the majority rule on the basis it would discourage creditors from dealing with debtors in financial straits:

> "The rule for which Mosier argues would discourage creditors from having any dealings with a financially troubled debtor. For instance, Ever-Fresh could have sold the goods to another purchaser and been able to retain the payment for those goods. Instead, Ever-Fresh would not only be required to forfeit all payments made by IRFM during the preference period, but Ever-Fresh would also lose the new value extended to the debtor. Mosier's rule also makes the creditor worse off vis-a-vis the other creditors. By refusing to permit the creditor to receive some benefit for the transfer of the new value, the proposed rule would put the creditor in a worse position than those creditors who chose not to deal with the debtor."[2]

Likewise, in *Ladera Heights*, Judge Fenning stated that providing the lenient creditor a set-off encourages the creditor to extend new credit:

> "Penalizing creditors in a subsequent bankruptcy case for having continued to do business with such a debtor on a regular open account basis will undoubtedly discourage the very behavior that the preference exceptions purport to seek. Creditors are likely to cut off shipments to the debtor, destroying workout possibilities and forcing more debtors to file bankruptcy. The effect of the majority interpretation is that it 'will cause creditors to abandon debtors in need.'"[3]

As with the majority rule, those courts embracing the emerging viewpoint are concerned with the statute's policy regarding a creditor's replenishment of the estate after having received a preferential transfer. These courts determine that to the extent that each repayment by the debtor is itself an avoidable transfer, each subsequent advance returns value previously transferred.

In *IRFM*, the bankruptcy court also addressed the practical problem of applying the majority rule in the following way. Since a debtor controls the amount of a transfer made after a subsequent advance, to require that the subsequent advance remain unpaid would mean that the debtor could eliminate a (c)(4) defense by making a large preferential transfer just prior to filing bankruptcy to pay for the subsequent advance.

Courts following the emerging viewpoint criticize the fact that most courts that have espoused the majority rule have done so without analysis. In *Check Reporting*, the bankruptcy court traced the origin of the unpaid requirement promulgated in a three-part test by the *Bishop* bankruptcy court and found that nearly all of the courts espousing the majority rule did not interpret the language of the statute itself to support their adoption of the rule, but instead merely made a rote recitation of *Bishop* and string citation of concurring authority. Those courts recently embracing the emerging viewpoint, however, not only analyze the statutory language but engage in exhaustive analysis of the underpinnings of the statute.

Further criticisms assert that the majority rule's rationale leads to inequitable results. Under the majority rule the trustee may recover the same amount twice; the creditor must both relinquish the payment received and lose the new credit extended. The Ninth Circuit in *IRFM* discussed this double-counting problem:

> "Assume IRFM made a preferential transfer of $50,000 to Ever-Fresh sixty days prior to filing bankruptcy. Subsequent to this transfer, Ever-Fresh give IRFM new credit valued at $100,000. If bankruptcy were filed on this day, Ever-Fresh would be able to successfully assert a new value defense and retain the $50,000 transferred by the debtor. However, if one week before bankruptcy IRFM made another transfer to Ever-Fresh of $50,000, under Mosier's rule, Mosier would be able to avoid the entire $100,000 transfer by the debtor. This result follows because none of the new value remains 'unpaid.'"[4]

Under this rule, Mosier may "double count" the second preferential transfer. First, Mosier may properly avoid the second $50,000 transfer because Ever-Fresh transferred no new value subsequent to this preference. Second, Mosier may also use this second transfer to "pay" for the new value, allowing Mosier to recoup the first $50,000 which had previously been subject to a valid new value defense.

This opportunity for the estate to double-dip is eliminated to the extent that the subsequent advance is paid for with a transfer which is subject to avoidance. This "otherwise unavoidable" requirement contained in § 547(c)(4)(B), discussed *supra*, was considered by Professor Countrymen:

> "If the debtor has made payments for goods or services that the creditor supplied on unsecured credit after an earlier preference, *and if these subsequent payments are themselves voidable as preferences* (or any other ground), then under § 547(c)(4)(B) the creditor should be able to invoke these unsecured credit extensions as a defense to the recovery of the *earlier* voidable preference. On the other hand, the debtor's subsequent payments might not be voidable on any other ground and not voidable under § 547, because the goods and services were given C.O.D. rather than on credit, or because the creditor has a defense under § 547(c)(1), (2), or (3). In

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REWRITING THE PREFERENCE LAWS: PROPOSAL MADE TO NATIONAL BANKRUPTCY REVIEW COMMISSION (Continued)

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executive has valid defenses. Preference suits in this range appear nothing more than "shake down" and the beneficiaries of these preference actions are the trustee and his counsel. The Proposal to the Bankruptcy Review Commission is that $5,000 is the minimum preference action that may be pursued. The Proposal notes that this change is "an effort to protect smaller trade creditors (i) where the most prone to abusive litigation tactics, and (ii) who are the least likely to have received a significant preference that would imperil the policies underlying the preference power."

Venue Change: Suing the Vendor where it has its principal Place of Business

For a credit executive whose company is based, say, in Oregon and sells goods nationally, being sued, for $4,000 by a bankruptcy trustee where the case is pending, say in Wisconsin, is extremely inconvenient, thus making it more costly to defend. The proposal to the Bankruptcy Review Commission is that the preference law should be amended to require that a preference action seeking less than $10,000 must be brought in the bankruptcy court where the vendor has its principal place of business. This Proposal is to:

> "protect parties from 'noneconomic' actions brought by a trustee seeking to take advantage of the liklihood that it will cost the creditors more to litigate the action than the action itself seeks to recover . . . if a trustee or debtor in possession has to litigate in the creditor's forum for all amounts between $5,000 to $10,000, more attention may be paid to possible affirmative defenses, thus reducing abusive preference actions."

Amending the Ordinary Course of Business Exception

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

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

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

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demands before it would agree to continue to manufacture for the Debtor: immediate payment on its prepetition claim and waiver of any preference claims. The Debtor wanted a commitment from Tenneco to continue to manufacture. Tenneco negotiated an agreement with the Debtor that would achieve both objectives. The agreement is discussed below.

Payment of Prepetition Claim

Prior to the bankruptcy, Tenneco had shipped its product to the Debtor on open account. At the time of the bankruptcy filing, Tenneco had a low six figure prepetition unsecured claim. Tenneco's past experience in bankruptcy was similar to that of many vendors: having to wait a significant time for a speculative percentage payment on its claims. Given this history, immediate payment of Tenneco's current claim was key to a continued trade relationship post-bankruptcy.

Waiving Alleged Preference Claims

During the 90 days prior to the bankruptcy petition, the Debtor had paid Tenneco approximately $200,000. One day prior to the bankruptcy filing, Tenneco also received a check from the Debtor for $55,000 that cleared post-bankruptcy. The creditors' committee initially contended that the most of the pre-petition payments Tenneco had received were recoverable under the preference laws. The committee also asserted that the $55,000 payment was recoverable as it was a post-bankruptcy payment which had not been approved by the bankruptcy court.

Tenneco established its preference defenses by analyzing invoices and the Debtor's payment history. It became apparent that Tenneco had viable preference defenses under the subsequent advance rule and ordinary course of business defense, significantly limiting Tenneco's preference exposure.

The preference analysis was shared with the Debtor and the creditors' committee, thus advising them of Tenneco's preference defenses.

Selling Post-Bankruptcy

Pre-bankruptcy Tenneco had filled the Debtor's purchase orders as they were issued. Tenneco never had an outputs contract or distribution agreement with the Debtor. Without such a contract, Tenneco could bypass the Debtor, who served as the distributor, and sell directly to the end user.

In exchange for a preference waiver and payment on Tenneco's prepetiton claim, the Debtor demanded that Tenneco enter into a distribution agreement. The Debtor also requested Tenneco sell on open account. The other vendors had terminated their open account sales to the Debtor upon the bankruptcy filing, forcing the Debtor to muster cash for COD and CIA purchases. One of the Debtor's goals was to reestablish vendor support. The Debtor was hoping that by getting Tenneco to sell on terms, other key vendors would also provide credit terms. Tenneco agreed to ship on open account, with the condition that it could offset any unpaid open account balance against the repayment of its prepetition claim, should the "claw back" provision be triggered.

The "Claw back" Provision

The creditors' committee demanded assurance that Tenneco would not renege on the agreement after the Debtor had paid Tenneco's claim in full and waived the preference claims. According to the committee, the break-even point for the bankruptcy estate in paying Tenneco's claim and waiving potential preference claims was a continued trade relationship of approximately 10-12 months. Tenneco agreed to a "claw back" provision should the agreement terminate prior to the bankruptcy estate receiving the benefit of its bargain. The "claw back" provision provided for a disgorgement of a pro-rated amount of the payment on Tenneco's prepetition claim. The pro-rata credit was calculated on the amount purchased from Tenneco during the agreement. The "claw back" provision also provided that the preference releases would be rescinded on a pro-rata basis should the estate not receive the benefit of its bargain.

Working with the Creditors' Committee

While the Debtor had agreed to the proposal, the creditors' committee had not. In Chapter 11, the creditors' committee comprises the major unsecured creditors of the debtor and is a watchdog for the interests of all unsecured of the debtor.

The creditors' committee filed an objection to the agreement. They contended the Debtor had shown extreme favoritism to Tenneco. The committee's principal complaint was that Tenneco was at no apparent risk to suffer any loss and, in fact, stood to gain a great deal at the expense of the other creditors. The committee would not consent to the agreement unless the "claw back" provision was included. The parties agreed to the terms of the "claw back" provision and the committee supported the agreement.

Persuading the Bankruptcy Court

The Debtor, the secured creditor, and now the creditors' committee, supported the agreement with Tenneco. Notwithstanding the support of all the major parties, the bankruptcy court had to determine whether the agreement was in the best interests of creditors. The court questioned why the longstanding bankruptcy policy of equal treatment for similarly-situated creditors should be abandoned in this instance. For the bankruptcy estate to release alleged preference claims and pay Tenneco's claim immediately, other creditors would need to see evidence that the continued supply of Tenneco's product was key to the Debtor's reorganization, thereby justifying such treatment.

The court also demanded evidence indicating that there were no alternative vendors capable of fulfilling the Debtor's needs. Additionally, the court questioned whether other unsecured creditors would receive distribution on their claims. The court expressed concern that many debtors fail to reorganize and fail to pay unsecured creditors. Here, the court noted, the Debtor

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proposed to pay an unsecured creditor in full at the start of the case when other unsecured creditors were not receiving such favorable treatment.

In response, the Debtor and Tenneco presented the history of their trade relationship to explain why Tenneco's business was irreplaceable. Historical and current income statements were presented by the Debtor's accountants and CFO establishing that Tenneco's trade relationship resulted in significant profits to the Debtor. The Debtor and Tenneco presented evidence that the Debtor had several hundred thousand dollars in orders that Tenneco needed to fill. The Debtor explained to the court that its orders on hand had to be immediately filled or end users would locate a substitute distributor. Tenneco was irreplaceable as a vendor, given the uniqueness of its product and production capacity, as well as the end-users' immediate need for the product. Tenneco explained to the court that because the Debtor was a distributor, Tenneco could bypass the Debtor and simply sell directly to the end user. This would effectively put the Debtor out of business altogether.

The Debtor's accountants presented two sets of projections showing the Debtor's operations over the next 180 days both with and without Tenneco's business. The projections with Tenneco's business showed that the Debtor would operate profitably. Without Tenneco's business, the Debtor could not service its secured debt and would be forced to liquidate. The Debtor's liquidation analysis established that prompt liquidation of the Debtor would result in payment only to the Debtor's secured creditor, with no distribution to hundreds of unsecured creditors. Liquidation would also result in the loss of hundreds of jobs. Because of the interrelationships of the Debtor's two other operating companies, the liquidation of the Debtor could likewise result in the liquidation of the related companies.

The court also wanted to ensure that Tenneco would not simply abandon its relationship with the Debtor after having received payment on its unsecured claim. Tenneco explained that the bankruptcy estate would get the benefit of its bargain as the agreement provided for a long term trade relationship and the "claw-back" provision. The court approved the agreement.

Conclusion

The necessity doctrine is not commonly applied. However, where the doctrine may apply, both the debtors and creditors stand to gain something. The "necessary" vendor can benefit by receiving early payment on its claim. The debtor may benefit by receiving needed product which may lead to a successful reorganization. Reorganization results in the other creditors receiving payment on their claims.

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> this situation, the creditor may keep his payments but has no § 547(c)(4) defense to the trustee's action to recover the earlier preference. In either event, the creditor gets credit only once for goods and services later supplied."[5]

Of course, if a creditor has retained an unavoidable security interest in a subsequent advance, or if the debtor has thereafter repaid the subsequent advance by means of "an otherwise unavoidable transfer," the subsequent advance rule prevents the creditor from relying on the new value exception because no effective replenishment of the estate has occurred.

V. A SAMPLE CALCULATION

The table below applies the subsequent advance rule under the analysis employed by courts adopting the emerging viewpoint.

CHECK DATE	CHECK AMOUNT	GOODS SHIPPED	PREFERENCE
		10,000.00	0.00
1/01/95	10,000.00		10,000.00
		10,000.00	0.00
1/30/95	20,000.00		20,000.00
		20,000.00	0.00
2/15/95	30,000.00		30,000.00
		30,000.00	0.00
2/28/95	10,000.00		10,000.00
		10,000.00	0.00
3/15/95	20,000.00		20,000.00
		20,000.00	0.00
3/25/95	Bankruptcy Filed		
TOTAL	$90,000.00	$100,000.00	$0.00

The "Check Date" column contains the date that the debtor delivered payments to the creditor for goods or services furnished (or credit for those goods or services). The "Goods Shipped" column carries the invoiced amounts of good or services provided by the creditor after receipt of the checks. The "Preference" column reflects the creditor's preference exposure between cycles of new value. Under the emerging viewpoint analysis, the creditor may offset preferences with subsequent advances of new value. The preferences may be carried forward by the creditor until exhausted by

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subsequent advances of new value. Under this view, the creditor has a (c)(4) defense based on goods shipped that protects all of the debtor's transfers to the creditor.

Under the analysis employed by a majority of courts, however, the debtor could use the preferential transfers twice to enrich the estate at the creditor's expense. First, the debtor could use the preference payments to offset the subsequent advances of $100,000. The debtor would then seek to recover $70,000 as preferential transfers. The subsequent advance following the March 15 transfer could be used to offset the March 15 transfer as it remains unpaid. The creditor would have to file a proof of claim for $70,000.

The majority rule penalizes the creditor for precisely what the policy objectives supporting the subsequent advance rule seek to advance: creditors supplying goods and extending credit to financially troubled debtors during the preference period. Under the majority rule, creditors will not supply troubled debtors because, as demonstrated in the sample calculation, the debtor ends up in a better position as a result of the preferences and subsequent advances, whereas the creditor is worse off. Moreover, in open account relationships, often the creditor conditions subsequent advances on the debtor's payment of a preceding shipment.

For example, if the creditor had refused to supply the debtor with additional goods unless the debtor paid for the initial shipment, the creditor is saying it will risk no more than $10,000 on this debtor. However, applying the majority rule, the creditor ends up losing the amount subject to recapture by the trustee as well as the value of its subsequent advances. Indeed, if the creditor had stopped shipping to the debtor after the initial $10,000 shipment, the debtor would not have received new merchandise worth $90,000. The value of these shipments to the troubled debtor exceeds the payments made by the debtor.

VI. CONCLUSION

The analysis employed by those courts adopting the emerging viewpoint, including the Ninth Circuit, better meets the legislative objective of encouraging creditor support to financially strapped debtors which may permit debtors a further chance to solve their problems and possibly avoid the need of bankruptcy, while discouraging creditors from racing to the courthouse, because subsequent advances will not be penalized.

The majority rule's interpretation of the subsequent advance rule, which is unsupported by the statute's language, undercuts this policy. Courts adopting the majority rule create a situation where a creditor extending further credit in reliance on prior payments faces an increased bankruptcy loss. The effect of this rule is that a creditor dealing with a debtor on open account will be unlikely to continue to deal with the debtor if virtually all of the debtor's payments are recoverable as preferences notwithstanding further shipments given by the creditor.

The emerging viewpoint also better recognizes the commercial realities of the debtor-creditor relationship. In deciding whether to furnish additional credit, a creditor does not look to one isolated transaction but rather the debtor's entire repayment history. Because the estate has been enhanced by the subsequent advance, the creditor and the estate are in the same position as if the preference had not been made. However, where the subsequent advance is paid for with an otherwise unavoidable transfer or the creditor has retained an unavoidable security interest in a subsequent advance, no replenishment has occurred and the subsequent advance rule should be unavailable.

1. © California Bankruptcy Forum. This article first appeared in the 1996 Edition of the California Bankruptcy Forum. A footnoted copy of the article provided upon request.
2. *IRFM*, 52 F.3d at 232.
3. *Ladera Heights*, 152 B.R. at 968 (citation omitted); *see also, Allied Cos.*, 155 B.R. at 744 ("Section 547(c)(4) allows creditors . . . who wish to limit their risk of nonpayment, to continue dealing with troubled debtors rather than cutting them of *IRFM*, 52 F.3d at 230 n.5. "once the highest acceptable risk is reached.")
4. *IRFM*, 52 F.3d at 230 n.5.
5. Countrymen, The Concept of a Voidable Preference in Bankruptcy, 38 Vand. L.R. 713, 788 (1985) (emphasis added) (footnotes omitted) (quoted in *IRFM*, 52 F.3d at 231-32).

STANDARD FINANCING STATEMENT NOT ENOUGH TO PERFECT INTEREST IN EQUIPMENT (Continued)

(continued from page 2)

> has been provided which evidences the debtor's intent to grant a security interest. Furthermore, neither the financing statement nor the invoices contain any language which evidences any intent to grant a security interest to [the vendor]."

Rather, for the vendor to be perfected in its interest in the equipment, a formal security agreement between the debtor and vendor was necessary in absence of some other document signed by the debtor, agreeing to grant the vendor a security interest in the equipment. The court found that the financing statement did not contain sufficient "words of grant" to create a security interest in favor of the vendor:

> "[W]hile it is possible for a financing statement and a security agreement to be one and the same document . . . it is not possible for a financing statement which does not contain the debtor's grant of a security interest to serve as a security agreement."

While there are no magic words required to create a security interest, use of words such as "collateral", "pledge", or "security" demonstrate that a debtor intended to grant a security interest in goods. Here, the vendor could only produce a financing statement with a list of collateral attached to it.

The Composite Document Theory Unavailable

The UCC requires that a court look to the substance rather than the form of the transaction to determine whether or not a transaction is a security agreement. A minority of courts recognize the "composite document" theory outlined above, wherein when parties have neglected to sign a separate security agreement, a court may look at the transaction as a whole considering all documents together to find the granting of a security interest. The composite document theory requires more documents than a mere financing statement to find evidence that the debtor intended to grant a security interest. Additional documents, such as a corporate resolution authorizing an officer or director to bind the corporation's assets, or a promissory note between the debtor and vendor, are needed to clearly evidence a debtor's intention of granting a security interest.

In *Arctic Air*, the vendor could not produce any additional documents evidencing the debtor's intent to grant a security interest in the equipment. Because of this, the *Arctic Air* court rejected the composite document argument, following instead the general rule set forth in *American Card Company*[2] that a financing statement, standing alone, in the absence of a separate formal document, cannot constitute a security agreement that satisfies the requirements of the UCC.

Protecting Your Goods

A vendor should heed the warning in *Arctic Air* and strictly comply with the UCC when selling equipment on credit. The vendor should ensure it has a separate signed security agreement with the debtor, and a duly filed financing statement containing an adequate description of the property. The *Arctic Air* decision reminds vendors that an enforceable security cannot exist in the absence of a written agreement containing words granting a security interest.

1. 202 B.R. 533 (Bankr. D.R.I. 1996).
2. 97 R.I. 59, 196 A.2 150 (1963).