Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

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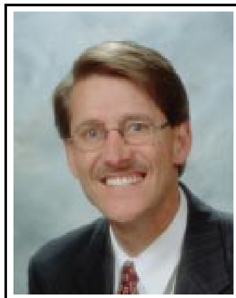
Developments in Commercial, Creditors' Rights, E-Commerce and Bankruptcy Law of Interest to the Credit and Financial Professional

SIGNATURES ON THE WEB'S DOTTED LINE: ARE ELECTRONIC OR DIGITAL SIGNATURES ON CREDIT APPLICATIONS AND GUARANTEES BINDING?

Scott Blakeley



The Internet is revolutionizing how credit professionals handle credit transactions. Credit professionals are using the Internet for a myriad of credit and financial functions, from credit research and scoring, to automatic invoicing customers through their Web site, to automatic payment posting. Credit departments are loading their Web sites with form credit application and guarantees. But does documenting your e-credit sale allow an electronic or digital signature (e-signature) to have the same legal effect as a handwritten signature from your customer on your credit application? What is the legal status of e-signatures documenting your personal and corporate guarantees over the Internet?

A number of states have recently adopted laws that allow the use of digital signatures in commercial transactions. Unfortunately, not all states have adopted e-signature law. And the e-signature laws that have been adopted by the states are not uniform. The U.S. Congress has recently stepped in and is considering adopting legislation that would make e-signature law uniform. The purpose of such federal legislation is to boost Internet credit transactions, both as to commercial and retail transactions. With the adoption of uniform laws on e-signatures, a credit professional whose company sells interstate will have a consistent rule of law as to the validity of e-signatures. This should boost commercial e-credit transactions. However, the proposed federal legislation has created controversy on a number of fronts, from disputes with state legislatures contending that the federal legislation is not needed, to disputes with consumer advocates who complain that e-signature legislation will result in consumers losing substantial legal protections in the event of a default on the credit sale.

What are Electronic, or Digital, Signatures

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

State and Federal Legislation

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

E-signatures have recently been accepted as legally binding to certify Internet contracts, including commercial contracts for the sale of goods, in 44 states. The problem with the state laws is that no two sets of laws are the same. With the conflicting state laws, the concern from e-lobbyists is that businesses may not take advantage of e-commerce. The federal government stepped in as a temporary measure once all states adopted a uniform digital signature standard. Early in 1999, the Commerce Department approved a bill providing that e-signatures had the same legal status as handwritten signatures. The bill applied to both commercial and consumer Internet transactions. The legislation was originally meant to create a uniform federal law recognizing the validity of e-signatures.

Under the e-signature legislation pending in both the House and the Senate, companies transacting business on the Internet would be able to notify parties of a default by e-mail, whether the defaulting parties were businesses or consumers.

Consumer Law Concerns

Opponents of the e-signature legislation believe that the legislation will allow com-

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CONSIGNMENT VENDOR'S FAILURE TO COMPLY WITH THE UCC MAY BE VIEWED AS A SECRET LIEN AND GOODS MAY BE LOST

Scott Blakeley

A sophisticated credit professional more than ever works closely with the sale's department to make the sale. One way a credit professional may make a sale to an otherwise financially shaky account that would not qualify for credit terms, is a sale on open account is a sale on consignment. Consignment sales minimize the risk of non-payment. A consignment transaction is not a true sale until the customer (consignee) actually sells the goods; until then, title remains with the owner, usually the manufacturer (consignor).

For the manufacturer or owner who puts up merchandise for sale, the process of selling inventory on consignment does introduce risk wherever there is the possibility of a competing creditor's claim. Inventory, or proceeds from the sale of that inventory, may become a target of other creditors unless the manufacturer has complied with the Uniform Commercial Code's (UCC) requirements for perfecting a security interest in the inventory. As the case of *In re Truck Accessories Distributing, Inc.* discussed belows shows, where a vendor selling on consignment fails to comply with the UCC, the vendor risks losing its inventory, or the proceeds from the sale of the inventory, to a competing creditor.

Consignment Sales

The technical definition of a consignment sale is one in which a consignee has taken possession of merchandise from the goods' owner. The owner is the consignor. The consignee has the obligation to pay the consignor from the proceeds of the sale of the merchandise. The consignee receives a commission or some other recompense for making the sale. If the consignee does not sell the goods after all, he may return them to the consignor without obligation. Title to goods on consignment remains with the consignor until the sale takes place.

FROM THE PUBLISHER:

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

Complying With The UCC

Article 9 of the UCC's perfection requirements provides the means whereby a manufacturer, or consignor, can establish a valid security interest in his own inventory, even when that inventory has been delivered to a consignee. Compliance with the perfection requirements of the UCC not only protects ownership of inventory; in the event of a dispute over the goods, the consignor will prevail over a competing creditor.

Perfecting a security interest in inventory takes several steps that begins with the consignor. An agreement is executed describing the relationship of the parties involved (i.e., the owner is consignor and the seller is consignee); a description of the inventory; and agreement that title to the merchandise only passes to third-party buyers. Then the consignor completes a UCC-1 financing statement which again describes the inventory and makes clear that the inventory is delivered on consignment. The consignor then files the statement with the filing office (usually the Secretary of State).

The consignor seeking to establish a security interest in its inventory must take additional steps if the consignee has a pre-existing, inventory-secured creditor. For the consignor's security interest in its inventory to prime the lien of a pre-existing secured creditor, the consignor should first make sure that its UCC-1 and consignment agreement has already been recorded at the time the consignee receives possession of the inventory.

Secondly, the consignor must give written notice to any pre-existing, inventory-secured creditor. It is the consignor's responsibility to check the filing office to determine that the consignee-debtor and its secured creditor have filed financing statements covering inventory and after-acquired property The consignor's written notice to the inventory-secured creditor should state that the consignor is delivering inventory on consignment to the consignor-debtor. The notice should describe the merchandise.

A consignor must give notice to any creditor asserting a security interest in the debtor's inventory in order to avoid any appearance that inventory coming to the consignor-debtor is free from ownership claims. This notice also distinguishes the 'new' merchandise on consignment from other inventory that is subject to the after-acquired property clause contained in the creditor's security agreement. The consignor that takes these steps is entitled to the identifiable cash proceeds from the sale of its merchandise, or to the return of the merchandise itself.

To have priority in the accounts receivable generated by the sale of consigned goods, the consignor must also comply with the UCC notice filing requirements as to accounts receivable.

If there is a pre-existing creditor, and the consignor has failed to give notice in the manner just described before he consignee received possession of the inventory, then the consignor has failed to perfect its interest in the consigned merchandise. Its priority in receipt of payment is thereby governed by the 'first to file' rule. This means that a pre-existing, inventory secured

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TIMING IS EVERYTHING WITH NEW VALUE PREFERENCE DEFENSE

Scott Blakeley

One of a credit professional's primary responsibilities is managing risk, especially with a problem account. Managing the risk can be a balancing act when the problem customer has been a significant source of sales. When a customer runs into cash flow problems and is unable to pay all of its vendors credit lines, vendors, understandably, cutoff or curtail credit. For the credit professional wanting to retain the troubled financial customer, the credit professional often releases goods to the debtor only upon receiving payment. What is the consequence when the financially troubled customer files for bankruptcy and your company has received a number of payments from the customer during the 90 days prior to the bankruptcy filing, the so-called preference period, and you made several shipments of goods during the preference period. What preference exposure do you have? Two recent bankruptcy decisions discuss the importance of timing for a credit professional in releasing goods to a financially troubled account to limit the preference exposure.

A. The Bankruptcy Preference Law

The Bankruptcy Code vests the trustce with far-reaching powers to avoid transfers and transactions prior to a bankruptcy filing. The power to avoid preferential transfers is out of the trustee's most potent weapons. 7be Bankruptcy Code defines a preferential transfer expansively to include nearly every transfer by an insolvent debtor during the preference period. Vendors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Debtors an deterred from preferring certain vendors by the requirement that any vendor that receives a greater payment than Similarly situated vendors disgorge the preference so that like vendors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period may be recaptured. One of the most effective and commonly used preference defenses used by a vendor is the new value or subsequent advance rule, which excludes from recapture those payments to a vendor who subsequently extends goods or services (or credit for those goods or services) to the debtor.

B. Beating the Preference Lawsuit: The New Value Defense

Timing is key for the vendor to have a new value defense, and operates as follows. For example, say on January 1 the debtor gives an unsecured vendor a check for $10,000 for goods furnished. On January 5, the vendor provides the debtor an additional $10,000 in goods on open account (no purchase money security interest is taken in the goods). On February 1, the debtor files bankruptcy, The January 1 payment, made within 90 days before bankruptcy, may be recaptured as a preference assuming that the criteria for the preference law were met. However, because the subsequent advance of goods by the vendor replenished the bankruptcy estate, the subsequent advance rule permits the vendor to set off its January 5 advance against the preference, and does not have to disgorge the payment. The vendor is left with an unsecured claim for $10,000.

The subsequent advance rule has its most frequent application where a vendor provides goods or services on open account and the debtor pays the vendor at various points during the preference period. Congress intended to protect the open account vendor with the new value rule. Under this analysis, a single transfer during the preference period is not analyzed in isolation from the overall course of business between the vendor and debtor, as the basis for maintaining the open account is the debtor's entire financial picture and not the debtor's most recent payment.

The objectives of the new value rule are: (1) to encourage vendors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy; (2) to promote equality among vendors; and (3) to reward vendors who actually enhance the estate during the preference

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SENDING INFORMATIONAL INVOICE TO DEBTOR MAY VIOLATE THE AUTOMATIC STAY

Scott Blakeley

You receive notice that your customer that you lease equipment to and have a maintenance agreement to service the equipment has filed for Chapter 11 or Chapter 13 bankruptcy. The bankruptcy filing leaves you with a prepetition unsecured claim. Postbankruptcy you continue to service the equipment and bill the debtor monthly, as provided in your prebankruptcy maintenance agreement. Your billing statements sent to the debtor reference the prebankruptcy delinquent account. 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 sending informational invoices to the debtor as to the prebankruptcy delinquent account constitute a violation of the Bankruptcy Code's automatic stay, especially when you have a continuing trade relationship with the debtor postbankruptcy? In a recent bankruptcy case, *In re Draper* [1], recently considered the question and found the vendor had violated the automatic stay and awarded sanctions.

Creditor's Informational Invoices

In *Draper*, a creditor held a secured claim against the debtor prebankruptcy. The debtor filed for Chapter 13 bankruptcy. The creditor sent the debtor monthly invoices. The invoices provided a statement:

> "Our records indicate that you filed bankruptcy, therefore, this statement is sent to you for information purposes only and does not alter or effect the terms of your bankruptcy proceedings. Please let us know if you wish us to discontinue sending your a monthly statement."[2]

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TIMING IS EVERYTHING WITH NEW VALUE PREFERENCE DEFENSE (Continued)

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period. Without the exception, a vendor who continues to extend credit to the debtor would merely be increasing its bankruptcy loss and in effect be punished for continuing to work with the debtor.

The objective of encouraging vendor support to a financially strapped debtor which may permit the debtor a further chance to solve its problems and possibly avoid the need of bankruptcy, while discouraging vendors from racing to the courthouse, because subsequent advances will be penalized.

C. Timing Is Everything With The New Value Defense

1. When The Vendor Ships the Goods Versus When The Debtor Receives The Goods

In *In re Eleva*, the vendor shipped goods on credit to the debtor on December 20 and December 27. On January 3 the debtor delievered a check for payment of the invoices on the two shipments. The debtor's parent received the shipments from the vendor on January 6 and January 9. The debtor unable to meet its debts, filed bankruptcy within 90 days of making payment to the vendor. The bankruptcy trustee sued the vendor for a preference demanding return of the payment for the two invoices. The vendor argued that the trustee was not entitled to recover the payment as it had a new value defense to the preference.

The court observed that the vendor shipped the goods to the debtor first and the debtor then made payment:

> 'The pupose of section 547(c)(4) is to encourage creditors to deal with troubled businesses. . . If that is the purpose, the Court believes that the relevant date to determine when the new value is given is the date of the shipment of the goods. In this case, [the vendor] extended credit and shipped the goods before the preference occurred. New value cannot be given as an afore-thought. Further, use of the delivery date would treat creditors arbitrarily based on the method of shipment used or distance the product must travel.'

The court observed that with services they are relinqushed at the time when rendered, unlike with a vendor's shipment of goods where there is delay from shipment to the debtor's receipt. The court ruled that the vendor did not have a new value defense.

2. When The Check Is Received By The Vendor Versus When The Check Clears

In *In re Sonicraft*, the court focused on when the new value defense should be considered from the veiw of the instance when the vendor receives payment by check. The question before the court was whether the new value defense should be measured from the date that the vendor receives the check or when the check clears the vendor's bank. The court observed that the purpose of the new value defense was to encourage vendors to contue to sell to a financially troubled debtor. If a vendor was required to wait until the debtor's check cleared before the new value defense applied, a vendor would delay shipment hastening a debtor's slide into bankruptcy. The court ruled that the new value defense applied when the vendor received the debtor's check as opposed to when the check cleared the vendor's bank.

D. Ensuring A New Value Defense

The *Elvea and Sonicraft* opions emphasize that a credit professional must be mindful of timing of shipments when continuing to sell to a financially troubled account. For a new value defense to apply to a preference lawsuit, the vendor must ship goods after it receives payment, not prior to payment. If the debtor pays for the new shipment by check, the vendor need not wait until the check clears for the new value defense to apply. A credit professional that recognizes that timing is everything for the new value defense to apply, may find a solid defense if the debtor they continue to sell files bankruptcy and is sued for a preference.

SIGNATURES ON THE WEB'S DOTTED LINE: ARE ELECTRONIC OR DIGITAL SIGNATURES ON CREDIT APPLICATIONS AND GUARANTEES BINDING? (Continued)

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panies to sidestep longstanding consumer notification laws. Consumers, it is argued, may not know that the fine print of their Internet contract eliminates the requirement for traditional notification of default. Or the consumer may never get crucial information if they change their Internet service provider or e-mail address.

In response to the consumer critics, the legislation has been revised and proposes that state and federal consumer-notification still apply, but that notification may be made electronically only if the consumer has agreed by separate agreement.

European View

The European Union (EU), which comprises 15 European countries, recently passed the Electronic Signature Directive. The European law provides that an electronic signature is presumed valid as a handwritten one in EU countries.

E-Signatures: What It May Mean For The Credit Professional

Transacting commercial credit sales via the Internet means lower transaction costs for the vendor. However, a credit professional must have a reliable way to certify an Internet contract. With the proposed federal legislation, a credit professional may transact credit sales over the Internet and bind the customer with an e-signature, rather a handwritten signature. This step will further the use of Internet contracts, as well as guarantees, by credit professionals.

SENDING INFORMATIONAL INVOICE TO DEBTOR MAY VIOLATE THE AUTOMATIC STAY (Continued)

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The creditor's invoices set forth the amount of payments past due and requested the debtor to pay the delinquent amount. The debtor and his counsel made several calls to the creditor requesting that they stop sending the monthly invoices. The creditor did not stop sending the invoices.

Debtor Claims Damages For Violation Of Stay

The debtor contended that the creditor willfully violated the automatic stay by sending the monthly invoice after 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 creditor claimed that the invoices were sent solely for information purposes and not to collect a debt.

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 field, whether the bankruptcy filing is one under Chapter 7, 11 or 13, whether the case was 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.

Informational Invoice Pressures Debtor to Pay and Violates the Stay

The court found that despite the creditor's contention that the monthly invoice was sent to the debtor merely to inform, the creditor violated the automatic stay as such invoices sought payment from the debtor:

> "[the creditor] points to the short paragraph contained in the invoice which indicates that because of the Debtor's bankruptcy, the invoice is being sent for informational purposes only. This self-serving statement does not obviate the fact that the invoice seeks payment from the Debtor. Any act taken by a creditor designed to collect a prepetition debt violates the stay if it amounts to pressure on the debtor to pay."[3]

The court found that the invoices were intended to pressure the debtor to pay the creditor its prepetition debt. The court sanctioned the creditor for violation of the stay, including awarding payment of the debtor's attorneys fees and ordered the creditor to stop sending the invoices.

Communicating with the Debtor Postbankruptcy

The *Draper* 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 and thus a violation of the automatic stay. The *Draper* court was bothered that the creditor refused to honor the debtor's repeated requests to cease sending invoices regarding its prepetition claim. 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.

[1] 237 B.R. 502 (Bankr. M.D. Fla. 1999).
[2] 237 B.R. at 502-03.
[3] 237 B.R at 504.

CONSIGNMENT VENDOR'S FAILURE TO COMPLY WITH THE UCC MAY BE VIEWED AS A SECRET LIEN AND GOODS MAY BE LOST (Continued)

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creditor's lien would take priority over a consignor's security interest.

Debtor Known To Sell On Consignment

An exception to the consignor's need to comply with the UCC Article 9 notice requirement, and an issue in *Truck Accessories Distributing*, is where the debtor is generally known by its creditors to be engaged in consignment sales. However, in a priority fight with a competing creditor or trustee over the same collateral, it is a heavy burden for a consignor to convince a court that the debtor's creditors indeed knew that the debtor was engaged in selling the goods of others on consignment.

Informal Consignment Arrangement Between Vendor and Debtor

In Truck Accessories Distributing, the debtor distributed truck accessories. The vendor contending a consignment arrangement (the consignment vendor) with the debtor manufactured truck accessories, which the debtor resold. The consignment arrangement between the parties provided that: (1) the debtor would keep the consignment vendor's product in a separate building from other inventory; (2) the consignment vendor would bear the cost of shipping; (3) the debtor would remit to the consignment vendor sale proceeds from its product on a weekly basis; and (4) the debtor would assess the consignment vendor a 5% warehousing fee and 5% handling fee. If the consignment vendor's goods were not sold, the debtor received nothing. The debtor incurred no risk other than its costs of doing business. The consignment vendor did not comply with the terms of the UCC and file a financing statement with the filing office, the secretary of state, notifying the world of the consignment arrangement.

Prior to entering into the consignment arrangement, the debtor had obtained a bank loan. The bank was granted a security interest in the debtor's assets, including existing and after-acquired inventory. The debtor ran into financial difficulty and was forced to file Chapter 7 liquidation. The bank sought relief from the automatic so as to foreclose on the debtor's inventory, including the consignment vendor's inventory. The consignment vendor opposed the relief from stay request as to its inventory, contending that it still owned the inventory, not the debtor, and thus had greater rights to this inventory than the bank.

The trial court ruled that the bank had a superior right to the consignment vendor's vendor, and denied the claims of the consignor.

Risk Of Loss On Consignment Vendor

The court observed that when non-consigning creditors know of a debtor's consignment arrangements with a vendor they can take precautions to protect their open account sales. That is the reasoning behind excusing a consignment vendor from complying with the UCC's notice provisions. From the non-consigning creditors view, consignment arrangements were undisclosed — the infamous 'secret liens' that the drafters of the UCC loathe. Such undisclosed arrangements take proceeds from the debtor's sales that otherwise would be used to pay unsecured creditors.

> 'The basis for this hostility to consignment arrangements from the bankruptcy courts is fairly obvious. Regardless of the legal theory of the consignment, in practical operation it looks like a sales transaction in which the unpaid seller retains a secret lien in his goods. From a creditor's point of view, the consigned goods appear to be part of the regular inventory of the consignee which, therefore, ought to be subject to their claims.'

The court stated that the consignment vendor became an unsecured creditor upon the sale of its inventory and had no priority claim unless it had complied with the perfection requirements of Article 9 of the UCC. The court determined that by virtue of security agreement and financing statement, the bank had a security interest in the consignment vendor's inventory.

Comply Or Risk Losing Your Goods

The *Truck Accessories Distributing* ruling reminds vendors considering consignment sales that such sales are more than mere 'sale or return' transactions. When a party delivers merchandise to a customer to sell, but with the right to receive back the unsold merchandise, the transaction is nothing more than a sale, thus making the selling party (who believed it was a consignment creditor) merely a general unsecured creditor. Since adoption of the UCC, consignment sales have changed. Failure to comply with the notice provisions of the UCC puts the consignor's inventory at risk to existing and subsequent inventory lenders, unsecured creditors' committees and a bankruptcy trustee, e.g., while the non-perfected consignment vendor waits for its inventory to be sold, creditors may rush in and levy this inventory to satisfy their claims.

The intent of the UCC is to compel a consignment vendor to comply with the filing statutes. Unrecorded consignment agreements are viewed as 'secret liens' and are disfavored as they do not give general creditors the opportunity to protect themselves. Creditors of a debtor in a 'sale or return' transaction naturally conclude that goods held by a debtor belong to the debtor. Consignment sales that do not create a hidden lien are to be left alone.