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

RECONSIDERING A PERSONAL GUARANTEE AS A CREDIT ENHANCEMENT: YOUR GUARANTOR MAY BE SHIELDING ASSETS WITH AN ASSET PROTECTION TRUST AS A RESULT OF SARBANES OXLEY ACT

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For credit professionals, personal guarantees furnished by a company's officer can increase the prospect for payment. A personal guarantee provides the vendor with a second pocket to look to, in the event the corporate customer fails to pay. A credit executive must take certain steps to ensure he or she has a valid guaranty to avoid unnecessary legal attacks by the guarantor.

For example, the language in the guarantee should clearly state that the particular individual signing the guaranty is agreeing to answer for the debt of another. In today's legal environment, the credit professional must now scrutinize whether the guarantor has shielded his or her assets under an asset protection trust, perhaps putting assets to pay for the corporate sale out of reach.

Congress enacted federal legislation, the Sarbanes Oxley Act (SOA), to combat corporate fraud. Recent reports of corporate fraud, from Enron to WorldCom to Global Crossing, is estimated to have cost the economy $200 billion. SOA requires more accurate financial disclosure and reporting from public companies. The CEO and CFO must sign a certification that the company's periodic reports, 10-Q and 10-K reports do not contain untrue statements. All financial information must accurately present the company's financial conditions and results of operation for the period.

As a result of SOA, company officers are looking for ways to protect their personal assets. Asset protection trusts are now being used by officers to attempt to protect their assets from creditor claims. What is an asset protection trust? Does an asset protection trust protect the personal assets of a guarantor from a creditor seeking to collect on a judgment?

Sarbanes Oxley Act and Management's Personal Liability

SOA was adopted to combat the wave of fraudulent accounting and financial reporting scandals and corporate bankruptcies. SOA focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. SOA imposes a number of duties and restrictions on officers and management of publicly traded companies. The CEO and CFO must sign a certification that the company's periodic reports, 10-Q and 10-K reports, do not contain untrue statements. All financial information must accurately present the company's financial conditions and results of operation for the

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PREFERENCE RECOVERIES: WHO IS TO BENEFIT?

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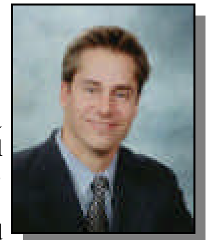

Traditionally, a debtor or trustee will pursue preference actions against unsecured creditors who received transfers from the debtor within the 90 days immediately preceding the petition date and equally redistribute the recovered monies to the debtor's unsecured creditors. It is increasingly common, however, for creditors to find themselves the subject of a preference action by third parties who have been assigned avoidance powers from a debtor's estate. More troubling is the situation where a third party is assigned avoidance powers and recoveries are not to be redistributed to unsecured creditors, but, instead, to a debtor's secured creditors. In this circumstance, the question must be asked - are the preference actions for the benefit of the estate?

This is the situation presented in *Mellon Bank, N.A.* v. *Dick Corp. (In re Qualitech Steel Corp.),* 2003 WL 22861982 C.A.7 (Ind.). In *Qualitech*, the debtor's secured debts exceeded the value of its assets. Most creditors, both secured and unsecured, agreed that the best step was to sell Qualitech promptly as a going concern to someone willing to take the risk of trying to turn the business around. In order to finance its operations for the time necessary to effect a sale, a syndicate of lenders advanced some additional capital. In order to satisfy the prepetition secured creditors that did not want to participate, the bankruptcy judge promised them that, if the secured creditors' position deteriorated during the interim, they would be entitled to dibs on as

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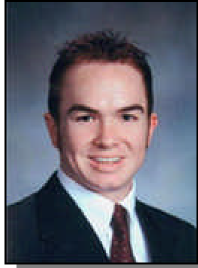
MUST THE VENDOR PROVIDE EXPERT TESTIMONY TO PROVE UP THE ORDINARY COURSE OF BUSINESS PREFERENCE DEFENSE?



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Vendors often complain that the cost of defending (and even prevailing on) a preference action can exceed the cost of simply paying a percentage of the preference demand to immediately settle the action, especially if the vendor must employ an expert to prove up the preference defense.

However, a bankruptcy court recently ruled that a vendor need not employ an expert in proving up the ordinary course of business defense. In *In re Bridge Information Systems, Inc.*, 297 B.R. 759 (Bankr.E. D.Mo.2003), the bankruptcy court ruled that non-expert testimony was sufficient for the creditor to establish the prevailing industry terms among similarly situated vendors faced with a similar transaction in which the debtor made the challenged payment. The court went on ease the creditor's burden by stating, "evidence need not be in the form of empirical data of the [creditor's] competitors' collection practices." This decision may open the door for the use of non-expert testimony to establish an ordinary course of business defense in a preference action case.

In *Bridge Systems*, the plan administrator filed a preference action against a vendor that had provided advertising services on credit. Despite the invoice terms, the common practice between the debtor and creditor, as well as the newspaper industry, was to accept late payment from continuing customers. Thus, the creditor asserted that the preference payments could not be avoided since they were remitted in the ordinary course of business.

Bankruptcy Code section 547(c)(2) provides that a preferential transfer may not be avoided to the extent that the transfer was: (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor; (B) made in the ordinary course of business or financial affairs of the debtor and the creditor; and (C) made according to ordinary business terms. The creditor must prove each of these elements by a preponderance of the evidence.

To prevail under section 547(c)(2)(C), the creditor must show that the "payment was objectively ordinary in relation to the standards prevailing among similarly situated companies within the relevant industry with respect to the type of transaction in which the debtor made the challenged payment." *Jones v. United Savings & Loan Assoc. (In re U.S.A. Inns)*, 9 F.3d 680, 685 (8th Cir. 1993). The *Jones* court went on to explain that "[t]his does not require the [creditor] to establish a uniform practice within the relevant industry, however, but only requires the [creditor] to demonstrate that the payment in question falls within the general range of terms that are prevailing within the industry. *Id.*

Bridge Systems is meaningful for the vendor as the bankruptcy court did not require "outside" expert testimony. The court found that "the [creditor] can meet its burden of proof under section 547(c)(2)(C) by producing the testimonial evidence of one [of] its employees as to the range of the prevailing practices within the relevant industry provided that *such testimony is based on the employee's first hand knowledge*." (emphasis added)

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FROM THE PUBLISHER:

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Guest Column

IS C.O.D. REALLY "CASH ON DELIVERY"?

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When selling to difficult or non-creditworthy customers, the conventional wisdom holds that it is a good idea to sell on a cash-on-delivery (C.O.D.) basis. The underlying assumption of requiring C.O.D. is that it eliminates any risk of payment. However, it appears this assumption may be incorrect. A recent bankruptcy filing has led to the conclusion that C.O.D. does not require "cash" to the carrier on delivery, but instead requires only "collection" by the carrier. *In re McFadden Systems Inc.*

In this case, a Pennsylvania manufacturer (vendor) sold to McFadden (debtor) a product used to manufacture 27-passenger motion simulators used worldwide in the entertainment industry. The vendor's product was a custom-made cushion, which in McFadden's manufacturing process was usually the last item installed prior to delivery. Without the cushion, the motion platform would not be useable. Competing vendors were not an issue because of the customized nature of the product.

Due to slow payments, the vendor was reluctant to continue to sell on an open-account basis, so the parties agreed to C.O.D., with a bank check required for payment. The vendor added to its invoice $10,000 in air freight charges, which were also to be collected by a bank check at time of delivery.

The cushion was delivered during the busy holiday season, when the freight carrier was employing temporary workers. When the shipment arrived at McFadden, instead of requiring payment by bank check, the driver accepted a McFadden company check for $60,000 (which included the $10,000 air freight charge). The check later bounced, and shortly thereafter McFadden filed chapter 11.

The vendor then demanded that the freight carrier pay the entire $60,000. The freight carrier refused and contended that its understanding of the term "C.O.D." means "collect on delivery," not "cash on delivery." The vendor was surprised by the response and inquired further. The freight carrier responded

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ACCEPTING CREDIT CARDS FOR B2B SALES: BE MINDFUL OF CUSTOMER'S PRIVACY RIGHTS

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Credit cards are transforming the way vendors receive payment on their commercial sales. A customer paying by credit card for the commercial sale allows the vendor immediate payment on the sale. The credit professional receiving payment by credit card for the first time may be surprised to find that an individual cardholder, say the company's CEO, offers their personal card to pay for the corporate sale. Frequent flier miles often prompt the individual to use the personal card for the sale.

However, with the dramatic increase use of credit cards to pay for commercial sales, is legislation protecting a customer's privacy rights to financial information. California has recently passed legislation that creates a duty for companies to protect electronic personal information from being disclosed, and requires companies to notify customers when their electronic information has possibly been misused. The privacy law identifies a customer's personal information to include their credit card number. Violation of the privacy law may be the basis of a lawsuit against the vendor. The dramatic rise of the crime of identity theft prompted the privacy legislation. What does the privacy law mean to the credit professional in managing a customer's credit card information?

Credit Cards May Make The Sale

The credit professional may find accepting credit cards as a way to make a sale to a marginal account. Like CIA and COD transactions, a customer's payment by credit card can be attractive to the vendor as it provides for immediate payment, prior to release of the goods. A credit card transaction acts like a credit enhancement, such as with a letter of credit or corporate guarantee, where the credit risk of the transaction can be managed. While a credit card transaction does carry risk of a customer chargeback, the credit professional can manage this risk through customer authorization which reduces or eliminates the likelihood of a disputed transaction.

Websites have emerged to protect the vendor from chargebacks, such as with the site www.nochargebacks.com. The vendor may also insist that the customer sign a terms and conditions agreement for payment by credit card that provides the customer will not report a disputed charge until they have notified the vendor. This provides the vendor with the opportunity to fix it.

Perhaps the biggest risk for the credit professional is the credit card transaction in the card not present (CNP) transaction, especially where payment is accepted through the Internet. There is a greater risk of fraudulent transactions with the CNP transaction as the vendor is not sure of the buyer's identity, and there is no signature and no card to imprint. The general rule is that the vendor assumes the risk of loss for these fraudulent payments.

To limit the risk of the fraudulent credit card transaction, the credit professional may develop a credit risk profile on each company seeking to pay with a credit card. The credit professional may then set a maximum limit that each company can buy based on the profile, regardless on whether the card company will authorize the credit card charge over the phone or Internet.

A Cardholder's Privacy Rights Under Recently Enacted Legislation

With the arrival of the electronic credit department and storing of a customer's financial information, such as credit card information, on a vendor's computers, there is a greater risk of computer hackers stealing this personal financial information for such crimes as identity theft. California's privacy law is intended to combat this.

The privacy law requires a company that does business in California to notify customers when there may have been unauthorized access, or a security breach, to their electronic personal information, including a customer's credit card information stored on the company's computers. The law does not define what constitutes a security breach, and the law requires notification even where the company only suspects there has been a breach.

The privacy law also requires that safeguards are in place to protect a customer's private information, including credit cards. The privacy law may apply to all states. The law is intended to protect

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"CRITICAL" VENDORS CONSIDERED ON A CLAIM-BY CLAIM BASIS, COURT RULES

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A hot topic for vendors is whether bankruptcy courts will continue to approve a debtor's request to approve its motion to pay critical vendors. In an increasing number of bankruptcy cases, "critical vendors" have been authorized to receive payments of prepetition claims by satisfying the elements of a three-prong test establishing preferential treatment. A recent decision by Texas bankruptcy court sets forth the requirements that a vendor must meet to be classified as a "critical vendor."

In *In re Mirant Corporation*, 296 B.R. 427 (Bankr. N.D. TX 2003) the Chapter 11 debtors, whose businesses involved the generation and sale of electric power, sought critical vendor status for certain of their vendors. Based upon their size and industry, the debtors argued that a disruption of their services could have had a meaningful, adverse effect on various segments of the national economy.

Initially, the court had reservations about granting the debtors critical vendor request. Granting such relief could result in certain favored unsecured creditors receiving treatment preferential to that received by other unsecured creditors under a plan.

The court determined "critical" vendors should be considered on claim-by-claim basis. The court concluded that such treatment should be accorded to a vendor: (1) that the debtors failure to deal with the vendor creates risk of harm or loss of economic advantage to estate that is disproportionate to vendor's prepetition claim, and (2) that there is no practical or legal alternative by which the debtor can cause the vendor to deal with it other than by payment of prepetition claim.

To avoid risk that debtors' business might otherwise be interrupted, the court did not require debtors, as prerequisite to providing preferential treatment for certain "critical" creditors outside plan, to first obtain advance approval from bankruptcy court after establishing the requirements

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THE EQUAL CREDIT OPPORTUNITY ACT, SPOUSAL GUARANTEES AND RELEASES

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Your credit application includes a form personal guarantee, that includes a spouse's guarantee. Given the downturn in the economy, you insist that the president and her husband of the corporation you are selling on credit sign the joint personal guarantee. You also obtain a spousal release of claims under the Equal Credit Opportunity Act (ECOA). You authorize the first-time credit sale to the corporation, and the corporation fails to pay. You make demand on the president and the spouse to honor the guarantee. They refuse and you sue on the guarantee. The spouse raises as a defense to pay on the guarantee that your company has violated the ECOA, notwithstanding the release. The spouse claims that the corporation was independently creditworthy, and was not involved with the business.

You are looking for ways to make the sale, but reduce the credit risk and personal guarantees may achieve this. But how can ECOA affect your taking a personal guarantee? Will a court honor a spousal release contained in the guarantee in the face of an ECOA claim? A state appellate court recently considered the interplay of ECOA, a spousal guarantee and spousal release, and is instructive for the credit professional.

What Is ECOA?

ECOA was enacted by Congress in 1989, and the Federal Reserve Board issued Regulation B to implement ECOA in 1990. ECOA is a federal statute that prohibits credit grantors from discriminating in the granting of credit based on a prohibited basis, including race, color, religion, national origin, gender, marital status or age.

As ECOA is a federal statute, it applies to all states. ECOA is intended to promote the availability of credit without regard to characteristics that have nothing to do with creditworthiness. Creditors are required to notify applicants of action taken on their applications, and to retain records of credit applications.

ECOA's prohibitions against discrimination are aimed primarily at the evaluation of a credit application by a credit grantor. The general rule is that a credit grantor may consider any information it obtains in evaluating whether to extend credit so long as the information is not used to discriminate against an applicant on a prohibited basis.

Obtaining A Spousal Guarantee

ECOA also bars a vendor demanding a guarantee from a spouse unless a vendor first determines that the applicant, say a corporation, does not qualify for the credit on its own. ECOA also does not permit a vendor to require a spouse to co-sign a personal guarantee if that spouse is not directly involved with the applicant. Unless the vendor can show that the applicant, say a corporation, is independently creditworthy, or that the spouse was involved in the applicant's business, the vendor may not condition the sale on the spouse being a co-guarantor.

ECOA Release Upheld

The facts supporting the Appellate Court's opinion is that the applicant, a partnership, requested credit. The spouse, who was not involved in the business, guaranteed the debt. The creditor obtained the spousal guarantee as a condition to restructuring the delinquent account as the husband did not have sufficient personal assets to cover the credit. The spouse also agreed to release the creditor from all claims relating to the credit. The partnership defaulted on the credit. The creditor sued the spouse on the guarantee when the debt was not paid.

The spouse responded to the creditor's lawsuit by contending that the creditor had violated ECOA and Regulation B as the partnership was independently creditworthy. The spouse contended the guarantee should not be enforced because of the ECOA and Regulation B violation. The Indiana Court of Appeals stated that before it can analyze the spouse's argument it must make a determination as to whether the spouse should be bound by the contract in which she waived her defense.

The Court found in favor of the creditor and against the spouse. The Court stated that there is a long tradition of recognizing and respecting the freedom of individuals to enter into contracts. Additionally, the Court has expressed a commitment to advancing public policy by supporting the enforcement of these contracts. As a general rule the law allows competent individuals the liberty to enter into agreements when done so freely and voluntary and will be enforced by the courts, so long as the contracts are not illegal or against public policy.

When a court reviews a contract that is in dispute, unless the contract is ambiguous (susceptible to more than one interpretation) the court will not consider any extrinsic evidence but rather will look only to the document itself and interpret the intent of the parties based upon the document only. Essentially, the court reviews the plain meaning of the words in the contract.

The Court found that the spouse was a sophisticated party, was represented by legal counsel and further had the opportunity to seek additional legal advice prior to signing the release of claims against the creditor. Additionally, there was no evidence before the court that the bargaining between the parties was anything other than free and open. Thus the Court stated that the guarantee, including the release, was plain and clear. As such, the spouse was bound by the terms of the contract, including the release waiving her right to pursue any claims or demands against creditor.

A Reminder When Taking A Spousal Guarantee

A personal guarantee provided by a company's officer, and spouse, of a corporation's debt is a method to increase the credit professional's security. However, be mindful of your credit application that includes a form spousal guarantee. ECOA may restrict your taking of this guarantee. If you do take the personal guarantee consider insisting on taking a spousal release. The Indiana Court of Appeals found that even if ECOA may have been violated, the spousal release may allow the creditor to avoid the consequences. A guarantor always looks for ways to escape liability from the guarantee. Don't have an ECOA violation result in your guarantee being ruled unenforceable.

RECONSIDERING A PERSONAL GUARANTEE AS A CREDIT ENHANCEMENT: YOUR GUARANTOR MAY BE SHIELDING ASSETS WITH AN ASSET PROTETECTION TRUST AS A RESULT OF SARBANES OXLEY ACT

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period.

Certifying officers must establish internal controls to ensure that employees provide material information regarding the company and its subsidiaries. Signing officers must also acknowledge that they have evaluated the company's internal financial controls within the 90 days before the filing of the report. The report must include conclusions of their evaluation. Certification must also state that the CEO and CFO have reported to the auditors and audit committee of the company all information regarding significant deficiencies in internal controls that could adversely affect the company's ability to provide an accurate report.

The CEO must sign the company's tax returns. An officer or director that knowingly makes a false certification may be fined up to $5 million and jailed for up to 20 years.

Under SOA, if a company is required to make an accounting restatement due to material noncompliance with any of the reporting requirements, the CEO and the CFO must reimburse the company for any bonus or other incentive-based or equity-based compensation during the 12 month period following first public issuance or filing with the SEC and any profits realized from the sale of securities of the company during that 12-month period.

Given the certifications of financial information officers and management are now required to provide, it is no surprise that asset protection trusts are becoming popular. What is an asset protection trust? Do they protect the guarantor's personal assets?

Asset Protection Trusts

An individual may consider two types of asset protection trusts, the Offshore Asset Protection Trust (OAPT) and the Domestic Asset Protection Trust (APT).

An OAPT is a trust established "offshore," in a country that has strict laws protecting trust assets from creditors and enforcing secrecy. An OAPT may legally protect assets from bankruptcy or lawsuits.

The OAPT is established in a country where the laws favor the settler, or guarantor for purposes of this article, over the claims of creditors without stripping the guarantor of control in the assets of the trust.

Once the trust assets are in danger of a lawsuit or judgment, an OAPT usually will not help. As a general rule, fraudulent conveyance statutes restrict asset transfers after a claim or lawsuit has been filed by a creditor.

Domestic Asset Protection Trusts (APT) have a short history in the United States. The 1997 adoption of asset protection statutes by Delaware and Alaska generated interest in domestic asset protection trusts.

The state statutes appear to protect against claims of creditors, particularly claims of creditors whose claims arise after assets are transferred to the trust. A vendor should be mindful that the APT may create a "tail" period following the asset transfer to the trust that provides that upon expiration of the tail period claims of future creditors are barred.

As for bankruptcy and asset protection trusts, the Bankruptcy Code exempts a debtor's interest in a trust that is subject to restrictions on transfer to the extent that such restrictions are enforceable under "applicable nonbankruptcy law."

The purpose of the Bankruptcy Code exemption is to preserve rights to property the debtor may have under state law, not to expand the rights of creditors to reach property in bankruptcy that would be unreachable in a nonbankruptcy proceeding in state court. The fact that the guarantor may have an interest in the property held in the asset protection trust should not alter the result.

Conclusion

SOA is prompting officers to take action to protect their personal assets. In light of this, vendors must scrutinize the personal assets of the individual personal guaranteeing the debt. An asset protection trust may put the guarantor's personal assets out of reach of the vendor's judgment, and, therefore, the guarantee may not provide that second pocket for payment.

On the other hand, even if the personal guarantee may be perceived to have questionable collectability because of the asset protection trust, the guarantee may create an allegiance with the credit professional=s company as opposed to a company shipping on open account without a personal guarantee. If the debtor company is not going to pay certain debts, the debtor=s officer will likely direct those debts that are not personally guaranteed to remain unpaid. Instead, the officer may marshal the debtor=s company=s scarce financial resources to pay personally-guaranteed debt to avoid personal lawsuits for collection of the debt.

While a personal guarantee may not be the preferred credit enhancement when the guarantor has created an asset protection trust, it may be better than merely selling the corporate customer on credit.

MUST THE VENDOR PROVIDE EXPERT TESTIMONY TO PROVE UP THE ORDINARY COURSE OF BUSINESS PREFERENCE DEFENSE?

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In the instant case, the vendor provided sworn testimony of its credit professional to establish the range of practices prevailing in the industry regarding the acceptance of late payments from customers. Accordingly, the court found that the vendor successfully defended the preference payments as the debtor made payments to the vendor in the ordinary course of business of both parties.

The gist of this decision provides that a vendor may use its own representative, who has direct knowledge about the practices of their industry, to defend a preference action in the applicable jurisdiction.

ACCEPTING CREDIT CARDS FOR B2B SALES: BE MINDFUL OF CUSTOMER'S PRIVACY RIGHTS

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customers from the risk of identity theft through notifying them of misuse of their personal information so they can take steps to protect their assets. The privacy law applies to those companies that store personal information, such as credit card information, on computers.

The privacy law requires a company give prompt notice to customers after a security breach. Notice may be via e-mail or regular mail. Should a company fail to disclose a security breach, it may be liable even if the customer's personal information is never used. A company is not required to notify law enforcement.

The privacy law is silent as to the mechanics for detecting and responding to a security breach. However, a company that encrypts the personal data may be exempt from it. The credit professional should consider how a customer's credit card information is stored. People's names should be kept separate from their credit card number.

The credit professional should have its company adopt a policy as to notification of California customers in the event of a security breach, storing credit card information and sharing credit card information with others in the company, such as the sales force, and third parties. To reduce the risk of a security breach, employee access to customers' credit card information should be restricted. The vendor should have a company policy manual advising of its policy dealing with credit card information.

Credit Department's Privacy Policy And Credit Cards

A customer's privacy rights are at the forefront of legislation and regulation, and these rights touch on the way the credit department manages a customer's personal credit card information. As the credit department goes electronic, a credit professional should be mindful of a customer's privacy rights and the how credit card information is stored. Given this, the credit professional should consider implementing a privacy policy as to the storing of a customer's credit card information.

IS C.O.D. REALLY "CASH ON DELIVERY"?

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that its service manual clearly stated that it was acting solely as an agent of the shipper (*i.e.,* the vendor), and that no liability would be assumed for bad checks, counterfeit bills, etc.

Adding further insult to injury, the freight carrier demanded payment of the $10,000 in air freight charges from the vendor. The carrier argued that it had performed the delivery service, and so the vendor was required to pay. Both parties agreed to put the matter "on hold" pending the outcome of the *McFadden* bankruptcy case. It has still not been resolved.

Clearly, this situation is a grave warning to those of us who ship on a C.O.D. basis. As a result of the vendor's experience, I reviewed the terms and conditions of the major freight carriers. Essentially, all use similar language, define C.O.D. as "collect on delivery" and disclaim any liability for bad checks or any problems in collecting payment.

On a C.O.D. tag, there is typically a box marked "check here if cash only; see instructions." In this case, the vendor did check the box marked "cash only," but failed to insert any wording in the instruction box. The freight carrier asserted that the vendor should have added the words "bank check only" or similar wording in that instruction box to alert the carrier to require payment by bank check.

Who is right? The instructions for C.O.D. tags typically state:

- "Cash only" must be entered on the instructions line and the box checked on receipts if the driver is not to accept a check issued by or on behalf of consignee (*i.e.,* McFadden).
- If the "cash only" box is checked, the carrier reserves the right to collect cash, cashier's check, certified check, money order or similar instrument.
- All payments are collected at shipper's (vendor's) risk.

Each carrier's service manual has similar instructions concerning C.O.D. shipments, such as the following:

> ...will be accepted by the carrier at the shipper's risk including, but not limited to, risk of non-payment and forgery, and the carrier shall not be liable upon any such instrument.

Based upon the plain language of this "instruction," it would appear that the risk of payment remains the responsibility of the shipper, even if the shipping documents are prepared properly.

What else could have been done? Hindsight is usually 20-20. Looking back, if the debtor had the funds on hand to pay C.O.D., then it could have paid by cash in advance a few days earlier. Because even a certified check could have been stopped, advance payment via a bank check or perhaps by wire could have been required. Further, the vendor may have missed a second valuable opportunity. At the moment the check first bounced, the vendor could have sent a reclamation demand to the debtor. The debtor then would have had to return the goods or, alternatively, the vendor might have ended up with an administrative claim, with its higher priority status, rather than an unsecured claim.

As a result of this experience, the vendor now has a new C.O.D. policy in place, including a reclamation letter ready to go out if the need arises. Perhaps other vendors need to "dust off" their C.O.D. policies as well.

"CRITICAL" VENDORS CONSIDERED ON A CLAIM-BY CLAIM BASIS, COURT RULES

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mentioned above for such preferential treatment. The court allowed the debtors to make advance payments to the "critical" vendors.

The *Mirant* court's ruling further establishes that courts still embrace the critical vendor doctrine but seek a principled basis to grant the debtor's request for preferential treatment to certain vendors.

PREFERENCE RECOVERIES: WHOSE BENEFITS ARE THEY ANYWAY?

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much as $30 million of Qualitech's remaining assets, including the value of any preference-recovery actions. The bankruptcy judge subsequently found that the secured creditors' position had in fact deteriorated, entitling them to the first $30 million of any preference- recovery actions.

The sale price of Qualitech was insufficient to cover both the new super-priority loans and the original secured loans. The original secured lenders' unsatisfied debts exceeded the value of any anticipated preference recoveries. Because at this point the estate was penniless, a committee of the secured lenders advanced funds to finance preference actions through Mellon Bank, which was appointed as the creditors' agent to collect on behalf of the (dissolved) Qualitech.

Mellon Bank pursued certain preference actions and recovered more than $10 million, and filed additional preference actions against Dick Corp. and GE Supply Co. for the recovery of roughly $1 million. Dick Corp. and GE responded and asserted two principal arguments: first that the entitlement to pursue avoidance actions had been sold with Qualitech's business, and second that the recoveries that would flow straight to the pockets of secured creditors are not "for the benefit of the estate" as § 550(a) uses that phrase. The bankruptcy court agreed with Dick Corp. and GE and dismissed the action. On appeal, the district court affirmed the judgment based on the principal that recoveries would flow straight to secured creditors, which is not for the benefit of the estate.

On appeal, the Court of Appeals for the Seventh Circuit considered the question of whether such recoveries benefit the estate. The Court of Appeals found that the potential to recover funds from preference recipients was put to use for the estate's benefit when the bankruptcy court promised this value to the objecting secured lenders to compensate them for risk while new super-secured funds were raised and the assets were sold. Instead of calling off the sale, or distributing some assets to the secured creditors, or taking some other step that (the bankruptcy judge believed at the time) would have made creditors as a whole worse off, the judge used the value of these assets to protect the secured creditors' position and thus facilitate what appeared to be the most productive course of action. Qualitech's assets were sold, and unsecured creditors received a bonus of $7.5 million. The Court of Appeals found that having put the prospect of preference recoveries to work for the benefit of all creditors (including the unsecured creditors) by effectively selling them to the secured creditors in exchange for forbearance, and in the process facilitating a swift sale that was beneficial all around, the bankruptcy judge did not need to use them a second time, for still another benefit to the estate; there was no further benefit to be had. The Court of Appeals reversed and remanded the action.

The rationale of the *Qualitech* court's decision is that imposing a rule that a quick sale of a business precludes avoidance actions by eliminating any benefit to the estate would derail many beneficial sales (because selling the business would reduce its value by abandoning opportunities to recover last-minute payouts). Unfortunately, the decision undermines the proposition that bankruptcy should not be used as a tool solely for the benefit of secured creditors - without a surcharge – and provides little comfort to the unsecured creditors who are the targets of such actions.

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Winter 2003

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

◊ Scott spoke to ***NACM/Kansas City*** regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to ***NACM National*** via teleconference regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to the ***NACM/Connecticut*** in New Orleans regarding ***Bankruptcy Preference.***

◊ Scott spoke to ***Reimer/RV Manufacturers Credit Group*** regarding ***Creditors' Rights***.

◊ Scott spoke to the ***NACM/MidAtlantic*** via teleconference regarding ***Credit Applications***.

◊ Scott spoke to ***IOMA*** via teleconference regarding the ***Sarbanes Oxley Act.***

◊ Scott spoke to the ***Credit Research Foundation*** in Nashville regarding ***Credit Enhancements and Bankruptcy***.

◊ Scott spoke to the ***OC Credit Professionals*** regarding ***Bankruptcy and Creditors' Rights***.

◊ Scott spoke to the ***Advertising and Media Credit Executives Group*** in San Francisco regarding ***Bankruptcy and Creditors' Rights***.

◊ Scott spoke to ***Food Group*** in San Diego regarding ***Creditors' Rights.***

◊ Scott spoke to the ***Gain Gift Group*** in Chicago regarding ***Bankruptcy.***

◊ Scott spoke at the ***Western Region Credit Conference*** regarding ***Credit Cards***.

◊ Scott spoke to ***Reimer Reporting*** in Las Vegas regarding ***Involuntary Bankruptcy Petitions***.

◊ Scott spoke to the ***NACM North Central*** via teleconference regarding ***Escheatment***.

◊ Scott spoke to ***NACM/Tampa's Sports Industry Credit Group*** in San Diego regarding ***Pre-Sale of Goods Issues***.

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