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MEASURING CREDIT AND BANKRUPTCY RISK: IS IT "BAD FAITH" FOR A SOLVENT DEBTOR TO FILE CHAPTER 11?

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A fundamental responsibility for the credit executive is assessing a customer's credit risk. Based on the risk assessment, a credit professional concludes the length and amount of credit terms, if any, including whether a credit enhancement, such as a personal or corporate guarantee, letter of credit or deposit, may be required. Key to this risk assessment is the credit professional's determination of insolvency risk, and, therefore, the prospects of a customer's bankruptcy filing. Indeed, Dr. Altman's Zscore theory has been used for years as a predictor of a company's probability of filing bankruptcy. A sophisticated credit professional is well aware of the downside with a customer's bankruptcy filing where credit has been extended on an unsecured basis: nominal recovery. Given this, the credit professional is vigilant in looking for red flags that may indicate a customer's bankruptcy may be in the offing, especially where a large order is placed by the customer and credit is requested.

But what if there are no red flags that a customer's bankruptcy is imminent. Rather, what if a customer elects to use a Chapter 11 filing as a business tool to limit creditors' claims, for example, even though the customer is otherwise solvent. May a debtor seek Chapter 11 protection, even though it is balance-sheet solvent, or can generally meet its debts when due? The Third Circuit Court of Appeals, in *In re Integrated Telecom*[1] recently considered the situation where a debtor filed Chapter 11 and was balance sheet solvent by several million dollars. The Third Circuit concluded that it was "bad faith" for the solvent debtor to file Chapter 11, and refused to confirm the Debtor's plan of liquidation. The court's opinion is considered below, as well as the impact on the credit professional attempting to measure credit and bankruptcy risk in such an environment.

Chapter 11 As A Business Tool

Over the last decade, Chapter 11 has lost its stigma at the upper levels of management. In considering alternatives when faced with a difficult operating environment, or financial challenges, management is more inclined to consider Chapter 11 as a tool to achieve a business solution. In recent years, management has used Chapter 11 to deal with, for example, future asbestos claims, an extraordinary judgment or environmental claims. Chapter 11 allows management to continue in control of the debtor as it attempts to achieve its solution management appears to view Chapter 11 as an alternative that customers, lenders and vendors are more understanding of.

Eligibility To File Chapter 11: Must A Debtor Be Insolvent?

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RELEASE OF INCOHOATE LIEN: DEFENSE TO RECOVER ALLEGED PREFERENTIAL TRANSFER?

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As a construction contractor, you perform your services and are paid by the customer. After payment, you release your inchoate lien - a lien right that has not yet been perfected through the filing of a mechanic's lien or action to foreclose. Thereafter, your customer files for bankruptcy and sues you for return of the payment. Trustees have successfully argued that once a lien is released, the creditor is not a secured creditor. As a result, the creditor received more than it would have in a chapter 7 liquidation and is forced to return the preferential payment. In the recent case of *Golfview Development Center, Inc.*, the creditor defeated the debtor's preference claim, demonstrating that an incohate lienholder is a secured creditor in the context of a preference claim.

In *Golfview Development Center*, the debtor contracted with a creditor to paint the interior of its leased building. The creditor completed the work and invoiced the debtor accordingly. The debtor submitted payment to the creditor, and the creditor forwarded a lien waiver to the debtor. Thereafter, the debtor filed the complaint to avoid and recover the transfer.

The parties disputed the fifth element of §547(b) - whether the creditor received more than it would have if the debtor had filed a liquidation case under chapter 7. The

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A VENDOR'S RIGHT TO A POSSESSORY LIEN

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What is a possessory lien? A possessory lien enables a vendor to retain that which is in its possession belonging to the debtor until certain demands of the vendor in possession are satisfied.

Possessory liens are statutorily created liens that secure payment or performance of an obligation for goods or services. Possessory liens are only effective when the creditor retains possession of the debtor's goods. Almost anything that is capable of possession may be the subject of a possessory lien. For example, in addition to goods, a debtor's documents may give rise to a possessory lien. However, possession taken by a wrongful act will not suffice.

How is a possessory lien created and how it can assist a vendor? Traditionally, a vendor could not assert a possessory lien if no debt is due and payable at the time the lien is asserted. In other words, if credit terms have been granted by a vendor, and those terms have not expired, a possessory lien cannot be asserted.

To explain the creation of a possessory lien, we turn to the uniform commercial code. U.C.C. § 9-310 (revised § 9-333) confers priority on a vendor who furnishes services or materials with respect to goods subject to a security interest, if (1) a local statute or rule of law gives a lien, (2) the lien is possessory, and (3) a local statute does not expressly provide otherwise. For example, pursuant to U.C.C. § 9-310, the auto mechanic who retains possession of a car until payment is made will have priority over prior security interests in the car if local law authorizes a mechanics' lien and does not offer a contrary priority rule. Notwithstanding a secured lender's security interest in the debtor's car, if the debtor refuses to pay and abandons the car in the mechanic's possession, the mechanic may assert a possessory lien on the car. The possessory lien secures the obligation to pay for the repair work. Essentially, possessory liens may have priority over a competing security interest in the same goods unless the possessory lien is created under a statute that states otherwise.

FROM THE PUBLISHER:

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How does a vendor use a possessory lien to satisfy the debt? More often than not the vendor will use the lien as leverage to persuade the debtor to pay up or complete performance. If necessary, the next step for the lienholder is to bring an action on the claim and execute on the resulting judgment. It is important to note that a lien by itself does not automatically incorporate a right to sale the property in the vendor's possession to satisfy the debt. Furthermore, a possessory lien does not automatically allow the vendor to charge the debtor for the costs of storage or upkeep incurred by the vendor. Actually, the most common difficulty with utilizing a possessory lien arises with the debtor's insolvency.

A vendor must be mindful when dealing with an insolvent debtor. A vendor claiming a possessory lien on a debtor who has filed for bankruptcy protection may be liable for violating the automatic stay if the vendor conditions the release of the goods upon payment of the prepetition debt. As most vendors are aware, the automatic stay is one of the most fundamental protections of bankruptcy. Section 362 of the Bankruptcy Code provides that the filing of a bankruptcy petition operates as a stay of any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the es-

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Guest Column

MECHANIC'S LIEN & BOND WAIVERS

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Mechanic's lien & bond claim waivers can appear in contracts and in waiver forms for progress and final payments. These waivers may permanently eliminate lien or bond rights, even for future deliveries or even if a bankruptcy court forces you to repay a payment received. Contractors must be able to review and revise waivers to preserve security rights.

Waiver in Contract

Many construction contracts state that the supplier waives lien rights on the project. This means what it says in most states. If you sign a contract with a waiver, courts may strike your lien. If the customer is insolvent, this probably means you just worked for nothing.

The importance of lien rights depends upon the financial strength of your customer. If the customer is never going to run out of money, your lien rights do not matter. If your customer is a small, closely held corporation with limited funds, your lien rights are absolutely critical.

In some states, such as Maryland, you cannot waive lien rights in your contract. The waiver must be in a separate document signed after the contract. The best practice, however, is to always eliminate lien waivers in your contract. In Pennsylvania, a general contractor can waive lien rights for all subs and suppliers before the project even starts. You must be aware of this before you supply materials in such states. See more tips for reviewing and revising construction contracts at www.FullertonLaw.com

Waiver Forms for Payments

Lien and bond waiver forms required with payment requisitions can be the kiss of death. It is very important to get your money, but do not let cash flow urgency result in long-term losses. Waiver forms vary greatly in their wording and effect. Recognize and revise what you are signing.

1. Have Your Own Waiver Forms Available

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CONFIDENTIAL INFORMATION AND CONFIDENTIALITY AGREEMENTS?

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When establishing a new business relationship there are uncertainties in the beginning regarding shipping goods, providing services and extending credit. Many companies will require that before they release private financial information, to help substantiate their credit worthiness, that a confidentiality agreement be signed.

Another common use of confidentiality agreements is when you are selected to serve on the creditors committee in a bankruptcy proceeding. Many decisions that the committee will make are based upon current finances of the debtor. The debtor may insist that a confidentiality agreement be signed before releasing private financial information to the committee.

Confidentiality agreements and non-disclosure agreements are contracts between two or more parties where the subject of the agreement is a promise that information conveyed will be maintained in secrecy. These agreements can be used to protect any type of information. The agreement can be mutual, where both parties become obligated to maintain secrecy, or a unilateral agreement, which only obligates one party. The structure of a confidentiality agreement depends upon the nature of the information to be protected and the needs of the party wishing to keep the information a secret.

I. What is Confidential Information

The most important part of the agreement is the definition of the confidential information. The confidentiality agreement should set forth as specifically as possible the scope of information covered by the agreement. The disclosing party may be reluctant to describe the information to the vendor in the contract for fear that some of the confidential information might be revealed in the contract itself.

A. Key Terms

1. Explanation of Purpose

The explanation of purpose for the disclosure of the confidential information to the vendor is another key component of the agreement. The disclosing party should choose to state the specific purposes for which the confidential information may be used by the vendor.

2. Disclosure Provision

Many agreements do not contain a disclosure provision. This provision states that in return for agreeing to keep the information confidential, the vendor has the right to receive the information. This puts a duty on the discloser to disclose its confidential information to the vendor and places a duty on the vendor to only use the information for the purposes included in the agreement.

The vendor who receives the information must agree not to disclose the information to third parties. This provision to a large extent controls the strength of the agreement. The agreement states the vendor must make their "best effort" to keep the information confidential, or whether to limit access to the confidential information to a "need to know" basis. The agreement may also state the vendor receiving the information must protect the information in a manner similar to the way it protects its own confidential information.

3. Limits on Confidential Information

Usually agreements will put limits on the type of information that will be deemed confidential. If the vendor already knew the information before it was revealed by the discloser, or if the information was revealed to the vendor by a third party, that information will not be treated as confidential. Other circumstances when confidential information may not be deemed confidential any longer are: when information becomes publicly known; information that is requested by order of a government agency; and information independently developed. The disclosing party may require a certain level of proof by the vendor before such information is considered non-confidential.

4. Term of the Agreement

The term provision of the agreement is extremely important. The term must be long enough to protect the interests of the disclosing party, but should not be unduly burdensome to the vendor.

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CHECK 21 AND NSF CHECKS

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You conclude that a new customer is too risky to grant open credit, so you insist on COD. You authorize shipment only on the condition that your delivery driver picks up the check from your customer. The goods are delivered, but the check is returned "NSF."

On October 28, 2004, an act known as the "Check 21 Act" went into affect. (Its official name is Check Clearing for the 21st Century Act.) This is federal legislation affecting all states. Check 21 changes the way that checks are processed in the United States, as well as the technology of check payment and acceptance. With Check 21, financial institutions are allowed to process checks electronically, instead of transporting the paper.

What is the impact of Check 21 and bad check laws? What steps do you need to take to enforce the bad check in light of Check 21?

Overview Of Bad Check Laws

State law governs bad check law and all states have such laws. These laws combat fraud: For example, when a buyer of goods leads you to believe that payment is being made by offering you a check (which turns out to be bad), and you release goods based on this, that can be fraud. However, the bad check laws do not protect credit or "open account" transactions.

Generally, you are required to establish the buyer's *intent* to defraud and knowledge of insufficient funds for a valid claim under the bad check laws. Most states provide that it is prima facie evidence of insufficient funds if:

(a) the check was not honored, and
(b) the buyer did not pay the check after written notice of dishonor of the check.

Under the bad check laws, you may have claims against the buyer on both a civil basis (collection of the debt) and a criminal basis.

Overview Of Check 21

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A DAY LATE AND HUNDREDS OF THOUSANDS OF DOLLARS SHORT: CALENDAR THOSE BAR DATE NOTICES!

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For a credit manager attempting to force payment of a delinquent account through e-mails and past due notices, the customer's filing bankruptcy forces an end of all collection efforts. Upon the filing of a bankruptcy petition, payments to unsecured creditors are suspended and the vendor is entitled to assert a claim for the unpaid value of their goods and services against the debtor. By virtue of the automatic stay, which arises upon the filing of the bankruptcy, creditors are enjoined from attempting to collect on their unsecured, pre-petition debt and instead must file a proof of claim (in most cases).

The Bankruptcy Code, Bankruptcy Rules and Local Rules provide the deadline and contents of a proof of claim, which is discussed below. However, the bar date requires the creditor to strictly comply with the last day to file a claim. If the creditor misses the bar date, the claim may be disallowed. Indeed, creditors in recent bankruptcies have learned painful lesson of missing bar dates, wherein courts have shown their inflexibility where creditors have missed bar dates and disallowed the late filed claims. These decisions are discussed below. What are a creditor's alternatives when the bar date is missed? Is the creditor's mistake "excusable"?

I. Filing Your Proof of Claim

The Bankruptcy Rules have different filing requirements depending on whether the debtor has filed a Chapter 11, Chapter 7 or Chapter 13 bankruptcy petition.

A. Chapter 11 Bankruptcy

Chapter 11 of the Bankruptcy Code provides for the reorganization of a debtor's assets and liabilities, and existing management continues to operate the business. The bankruptcy court serves creditors with notice of the bankruptcy filing and a form proof of claim.

1. Who Must File

A Chapter 11 debtor must file Bankruptcy Schedules and Statement of Financial Affairs within 15 days of the bankruptcy filing, unless the bankruptcy court extends the time period. A debtor must list all its prepetition debts in its schedules. If a creditor agrees with the debtor's scheduled amount of its claim, and the claim is not listed as disputed, contingent or unliquidated, a creditor need not file a claim. However, a debtor may schedule a creditor's claim as disputed, contingent or unliquidated by checking a small box contained on the schedules next to the creditor's claim. An unsecured creditor whose claim is scheduled as disputed, contingent or unliquidated must file a claim by the bar date, or the claim will be subordinate to the unsecured creditor class, which means the claim, as a practicable matter, will be disallowed. A devious debtor may schedule all of its unsecured claims as disputed, contingent or unliquidated in hopes that creditors will not file proofs of claims.

Where a Chapter 11 case is converted to Chapter 7, a creditor must file a proof of claim, whether or not a claim was filed in the Chapter 11 case.

2. When a Claim Must be Filed

With a Chapter 11, the bankruptcy court will establish a deadline in which all prepetition creditors must file their daims, which deadline is generally requested by the debtor. The deadline to file a claim is referred to as the bar date. The purpose of a bar date is to facilitate the efficient and orderly administration of claims against the estate. A claim filed after the bar date is disastrous for the creditor, as the late-filed claim is subordinate to unsecured claims and will not be paid unless there is surplus assets. A creditor scheduled by the debtor will receive written notice of the bar date. Depending on the complexity and size of the debtor, a bar date is usually set within the first 120 days of the Chapter 11.

3. Where a Claim Must be Filed

A creditor must file its claim with the bankruptcy court that is administering the Chapter 11 case. If a creditor does not file in the proper District the claim will be disallowed. The creditor must list the bankruptcy case number and the name of the debtor as stated in the bankruptcy petition.

B. Chapter 7 and 13 Bankruptcy

Chapter 7 of the Bankruptcy Code provides for liquidation of a debtor's assets by a trustee, an independent party, usually a lawyer or accountant, whose primary responsibilities are to gather the assets, liquidate the assets to cash and distribute the proceeds. Chapter 13 of the Bankruptcy Code deals with individuals with regular income attempting work out their financial difficulties.

1. Who Must File

With a Chapter 7 or Chapter 13, a creditor must file a proof of claim to participate in any distribution, whether or not the claim is scheduled as disputed, contingent or unliquidated.

2. When a Claim Must be Filed

With an individual Chapter 7 case, the bankruptcy court will send written notice that creditors need not file a claim unless assets are recovered. Otherwise, with a Chapter 7 or Chapter 13, a creditor must file a claim within 90 days after the First Meeting of Creditors. Late-filed claims are subordinate to unsecured creditors.

3. Where a Claim Must be Filed

A creditor must file its claim with the bankruptcy court that is administering the Chapter 7 or Chapter 13 case.

C. Proof of Claim Form

1. The Contents and Purpose of Formal Proof of Claim

A formal proof of claim must contain the following: the name of claimant and the capacity of the signatory; the amount of debt; the basis for the liability; the documents upon which liability is based; payments made, credited and deducted; and whether the claim is secured. The official bankruptcy proof of claim form (Form B10) is the recommended form and can be obtained from the clerk of the bankruptcy court.

Invoices, or a summary of the invoices if too voluminous, or other documents must be attached to the claim as evidence.

2. Informal Proof of Claim

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MEASURING CREDIT AND BANKRUPTCY RISK: IS IT "BAD FAITH" FOR A SOLVENT DEBTOR TO FILE CHAPTER 11?

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Management's view that there may no longer be a stigma attached to filing Chapter 11 (or at least greatly weakened) may be answered by looking to the Bankruptcy Code. The Bankruptcy Code does not impose a threshold financial standard for a debtor to file Chapter 11, such as liabilities exceeding assets or the debtor's inability to meet its debts when due (But the filing of an involuntary bankruptcy petition and the legal standard a petitioning creditor must establish, is that the debtor generally is not paying its debts when due). However, a benchmark for a Chapter 11 filing is traditionally a creditor chasing the debtor for payment. Indeed, often a debtor seeks Chapter 11 refuge to obtain the protection of the automatic stay, which enjoins creditors from seizing its assets. Notwithstanding that there is no financial standard for a voluntary Chapter 11 filing, a creditor, or creditor group, may challenge a debtor's Chapter 11 filing by raising whether the Chapter 11 was filed in "bad faith". A bankruptcy court may dismiss a Chapter 11 case upon a showing that the petition was filed in "bad faith". What is the criteria for a court to determine that a bankruptcy petition is filed in "bad faith"?

In *In re Integrated Telecom*, the Third Circuit, which includes the states Delaware, New Jersey, Pennsylvania and the Virgin Islands, held that a financially healthy debtor was ineligible to file Chapter 11. The Circuit Court noted the Debtor had ceased doing business and had no intention of reorganizing or liquidating as a going concern, and had no reasonable expectation that the Chapter 11 proceedings would maximize value for creditors. The court also found the Debtor filed bankruptcy solely to take advantage of provision of the Bankruptcy Code that capped the creditor's damage claim, and thus the bankruptcy petition was not filed in "good faith", and should be dismissed.

The Third Circuit Considers A Debtor's Financial Condition

In *In re Integrated Telecom*, the Debtor was a supplier of software and equipment to the broadband communications industry. The market for the Debtor's products deteriorated, causing it to suffer multi-million dollar losses. The Debtor elected to liquidate its assets outside of bankruptcy and dissolve under state law. The Debtor sold its assets. The Debtor had $105.4 million in cash and $1.5 million in other assets. The Debtor was solvent, with its assets exceeding its liabilities by several million dollars. As all of its assets had been sold, the Debtor had to deal with its former landlord. Based on its lease agreement, the landlord claimed it was entitled to a breach of contract damage claim, of $26 million. The Debtor demanded the landlord to settle its claim for $8 million, or the Debtor would file for bankruptcy so as to take advantage of the Bankruptcy Code's cap on a landlord's rejection damage claim.

The parties did not agree and the Debtor filed Chapter 11 and requested the Bankruptcy Court authorize rejection of the landlord's lease, thereby capping the landlord's damage claim. The creditor opposed the rejection of the lease on the grounds that the bankruptcy petition was not filed in "good faith". The Bankruptcy Court disagreed and confirmed the Debtor's plan of liquidation. The creditor appealed to the District Court, which affirmed the Bankruptcy Court's ruling. The creditor appealed to the Circuit Court of Appeals.

The Circuit Court reversed the lower court's ruling, finding the Debtor had filed the bankruptcy petition in "bad faith". Key to the Circuit Court's ruling was that the Debtor was not in financial distress and was not leveraged. The Court noted that a significant distribution was going to shareholders even though the Chapter 11 was filed. Further, two of the basic purposes of Chapter 11 would not be furthered with the bankruptcy filing, that of preserving going concern values and maximizing property available to satisfy creditors. The Court also questioned whether the bankruptcy petition was filed merely to obtain a litigation advantage.

The Court observed that the Debtor was out of business and therefore had no going concern value to preserve in Chapter 11 through reorganization or liquidation. The Court questioned whether the petition might maximize the value of the bankruptcy estate.

The Court observed that a "good faith" Chapter 11 filing requires a debtor be in financial distress. The Court pointed to the legislative history of the Bankruptcy Code which talks about a debtor in some form of financial difficulty. Absent that financial distress, a debtor has no need to rehabilitate or reorganize, its petition could not serve the reorganization purpose of Chapter 11. The Court noted:

> "Chapter 11 vests petitioners with considerable powers-the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, etc.-that can impose significant hardship on particular creditors. When financially troubled petitioners seek a chance to remain in business, the exercise of those powers is justified. But this is not so when a petitioner's amis lie outside those of the Bankruptcy Code.
>
> [T]he drafters of the Bankruptcy Code understood the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation. Such encouragement, however, does not open the door to premature filing, nor does it allow for the filing of a bankruptcy petition that lacks a valid reorganizational purpose.[2]"

Both the Bankruptcy Court and District Court concluded that the Debtor faced distress because it was losing money and was experiencing a downward spiral, and, as a result, had gone out of business. The Court of Appeals did not see how Chapter 11 offered the Debtor any relief from this sort of distress, which had no relation to any debt owed by the Debtor. There is no value for the Debtor's assets by the collapse of the Debtor.

The Court of Appeals concluded that the collapse of the Debtor's business model did not support a finding of "good faith". The Debtor was not suffering financial distress and the Bankruptcy Court and District Court's finding otherwise was in error. The failure of the Debtor's business did not subject the company to any pressure on the value of its assets that could be reduced or avoided in an orderly liquidation under Chapter 11.

The Lesson for Credit Executives

The *Integrated Telecom* circuit court ruling is encouraging for the credit

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MECHANIC'S LIEN & BOND WAIVERS

(*Continued from page 2*)

There will be times that you have the opportunity to use your own lien waiver form. Your customer may simply say "send me a waiver." You want to be able to safely do that. The form attached protects the interest of the owner or your customer without stripping you of legitimate security rights for unpaid labor or materials.

2. Bankruptcy Preference Risks

If you received a payment in the ninety days before a customer bankruptcy, you can be confident you will be sued. These preference actions have become common to the point of being expected. Preference actions are not normally filed, however, until almost two years after the bankruptcy filing. By that time, your lien and bond rights have long expired. There is no way to get these lien and bond rights back. You may need to repay the preference money, even though you had security rights at the time you received payment. There are a few essential steps to solving this problem.

First, make all of your lien and bond waivers conditional. You waive your security rights against the owner or bonding company as long as your customer does not file bankruptcy within ninety days after funds clear. Remember that the ninety days starts from the day that the check clears the debtor's bank, not the day you receive the check. Without a conditional waiver, your lien rights may be permanently gone, even if you have to pay the money back. Add the conditional waiver language discussed below to all lien and bond waivers.

Second, whenever a customer files bankruptcy, you must look at all payments received in the prior one hundred days. Treat this money the same as your uncollected receivable. Determine whether you have lien or bond rights. You may need to file a lien or make a bond claim on money you have already received. This is discussed in greater detail in the Bankruptcy Primer at wwwFullertonLaw.com

We have had good success seeking a resolution of preferences early in a bankruptcy, while the client still has lien or bond rights. Bankruptcy courts can shorten the time a bankruptcy trustee has to file a preference action and establish your lien or bond rights at the same time the court considers the preference claim against you. Get the bankruptcy debtor, the bonding company, the owner and the general contractor all in the same court at the same time. If you must repay the preference, the lien or bond rights still protect your receivable.

This strategy makes it more likely you can settle a preference case or get it dismissed. Preference actions are easier to resolve when the business people you know are still involved and you have easier access to witnesses and documents to establish preference defenses. The bankruptcy trustee usually brings preference actions long after all of the business people have left the bankruptcy company. You will have difficulty finding witnesses or documents you need from the owner or general contractor. The trustee has no incentive to settle and is not concerned with legal fees for a number of reasons. You will need to pay a settlement because of nuisance value.

3. Waivers for Partial Payment

Contractors are usually requested to sign waivers of lien at the time of each progress payment. Waiver forms presented for signature at that time vary greatly in their wording and effect.

The owner and your customer are entitled to a receipt for payments made and an agreement that you will not lien the project for payments you have received. A waiver form should not do any more than this. Owners or their title insurance companies usually produce the mechanic's lien waiver forms presented to you. They have a strong interest in making sure liens never succeed against the property. You must understand and revise these waivers.

a. Complete Waiver

A complete waiver of the right to ever lien a project often appears in a partial or progress payment waiver form. Partial waivers can completely waive mechanic's lien or bond rights for unpaid deliveries in the future, even if the initial progress payment is very small and even if valuable labor and materials are supplied later. Contractors often believe that lien rights are waived only to the extent of the payment received, if the waiver form recites a specific payment amount. This is not always true and a contractor should be careful to inspect the waiver form to determine the extent of rights waived. A complete waiver often appears something like this:

> In consideration of the sum of $_____ paid on account of labor and materials supplied through the _____ day of _____, 20___, and the receipt of which is hereby acknowledged, and other benefits accruing to us, and in favor of each and every party owning the property improved or in order to procure the making of one or more loans on said real estate, as improved, we do hereby waive, quit-claim in favor of each and every party making a loan on said real estate, as improved, and his or its successors and assigns, all right that we, or any of us, may now or hereafter have to a lien upon the land and improvements above described, by virtue of the laws of the state wherein said land is situate, or any amendments of said laws; and we do further warrant that we have not and will not assign our claims for payments, nor our right to perfect a lien against said property, and that we have the right to execute this waiver and release thereof.

In this example, the contractor should strike the underlined words and add the conditional language discussed below.

b. Waiver for Retention

Even a thinking contractor may inadvertently waive the right to lien for retention. Most contractors will sign the following waiver if put in front of them:

> In consideration of the sum of $_____ the receipt of which is hereby acknowledged, the undersigned does hereby waive, release and quit-claim the right to lien the described real estate for labor and materials supplied through the ____ day of _____, 20__.

This form may look acceptable. This contractor is only waiving the right to lien for labor and materials supplied up until the day the waiver is signed. If retention is still held on the project, however, the contractor has probably just waived the right to lien for that retention at a later time, since the retention is "for labor and materials sup-

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Guest Column

MECHANIC'S LIEN & BOND WAIVERS

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plied through today." In this case the contractor should add the words "except for retention" and use the cover-all conditional language discussed below.

c. Waiver for Unpaid Goods Delivered

This is similar to the previous problem on retention. A contractor may make multiple shipments or work multiple days on a job site, but now receive only partial payment for some of those materials. The contractor must expressly exclude the release of lien rights for the unpaid items. If the deliveries occurred on different days, be careful with the effective date of the release. Instead of filling in the date on which the release was signed, fill in the date of the last paid delivery.

3. Make Lien Waiver Forms Conditional

If you cannot provide your own waiver forms, the safest practice is to review and strike out offensive wording in the waiver. I am always happy to review waiver forms with clients. If clients do this a few times, they quickly learn how to deal with most waiver forms. There are only a few recurring problems on these forms. Also add the following statement just above your signature:

"This release will be effective only to the total amount of payments actually received without any bankruptcy filing for ninety days thereafter"

I have developed a rubber stamp with this statement, which you can put on any lien or bond waiver. Based on my understanding of the law, this stamp should avoid inadvertent waivers. This stamp is available by sending $5.00 with a request to this office. Please keep in mind, however, that this stamp is an innovation of mine and this wording has not been tested in the courts.

We hope these articles are helpful to you in understanding some of the concepts and issues involved in construction law. It is important to understand, however, that this law firm is not providing you legal or professional advice. We have generalized and simplified many legal concepts, so that the explanations are short, uncluttered and easily understandable. The law changes constantly and differs from state to state. Every set of facts and circumstances raise different legal issues. These articles are not a complete course on construction law but should give you some working knowledge that will be helpful to you in identifying problems. You should consult this firm or another attorney in dealing with any specific problem.

WAIVER

Date_____, 20_____

In consideration of the receipt of the amount of $_____, the undersigned does waive, release and quitclaim, only to the total amount of payments actually received without any bankruptcy filing for ninety days thereafter, all rights that it may have to a mechanic's lien or bond claim pursuant to the laws of any state for labor and materials furnished in and about the repair or construction of improvements to, or upon, the following described property:

The undersigned warrants that it has not and will not assign its claim for payment, nor its right to perfect a lien against said property, and that the person executing this waiver is authorized to do so.

COMPANY NAME:
_____

By_____

(Title_____

STATE OF _____;
COUNTY OF _____, to wit:

Subscribed and sworn to before the undersigned, a Notary Public in and for the County and State aforesaid, this _____day of _____, 20___.

_____
Notary Public

My commission expires:_____

James D. Fullerton is a partner in the law firm of Fullerton & Knowles, P.C.. Call him at (703) 818-2600 or visit the website at **www.FULLERTONLAW.com** to see a **Free 400 page** online internet **Construction Law Survival Manual.**

MEASURING CREDIT AND BANKRUPTCY RISK: IS IT "BAD FAITH" FOR A SOLVENT DEBTOR TO FILE CHAPTER 11?

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professional attempting to measure a customer's bankruptcy risk. The Third Circuit rejects a solvent debtor's attempt to use bankruptcy as a litigation tool to limit a creditor's right to full payment on their claim. The *Integrated Telecom* decision may force debtors to rethink a strategy of a bankruptcy filing to cap payment on a creditor's claim.

1. *In re Integrated Telecom Express, Inc.*, 2004 WL 2086058 C.A.(Del.), 2004.

2. *Integrated Telecom* at 2086059-60.

CONFIDENTIAL INFORMATION AND CONFIDENTIALITY AGREEMENTS?

(Continued from page 3)

5. Other Provisions

Some provisions may be optional depending upon the parties involved. These are provisions such as:

1. Provision calling for the return of confidential materials after use by the vendor;

2. Provision stating that discloser has the right to receive an injunction from a court if the agreement is breached by the vendor;

3. Provision specifying that disputes should be arbitrated;

4. Provision governing the controlling jurisdiction and law for the agreement.

6. Treatment of Materials Upon Termination

The confidentiality agreement should also address the treatment of materials storing the confidential information at the termination of the agreement by the vendor and disclosing party. The agreement should prohibit any further use of the information by the vendor. Also, outline whether or not the hard copies should be returned, materials should be destroyed, computer disks returned, and ensure permanent deletion of the material from all computers hard drives is mandatory.

7. Remedy for Breach

In the event that confidential information is leaked or shared in violation of the agreement by the vendor, the disclosing party will have a contractual legal remedy. As detailed previously, these agreements a merely contracts on how and when the confidential information may be shared and used. Courts will generally enforce private contracts so long as they are not against public policy. Unfortunately, it is often difficult and expensive to enforce the agreement. A party may seek injunctive relief which will prevent the violating party from any further breach of the agreement, or seek monetary damages. The monetary damages must be quantifiable at the time the confidential agreement was formed.

II. Creditor Committees and Confidentiality Agreements

It is extremely unusual for a creditors' committee to meet without its counsel, but the mere presence of counsel does not ensure that all of the committee's deliberations are privileged. Most, if not all, the committee's decisions are directed toward deciding what legal steps the committee should take in the pending bankruptcy. In the event there is a question regarding if deliberations are confidential, a factor influencing a court's decision is whether the evidence shows that the committee and its counsel intended these discussions to be privileged and for the purpose of obtaining legal advice.

A confidentiality agreement among committee members specifically agreeing that they will not divulge committee discussions is recommended. It is not uncommon for committee members to be unwilling to sign confidentiality agreements.

Instead of having the committee sign a formal confidentiality agreement, an alternative is having the committee members represent orally that they will keep extremely sensitive information confidential. In this event, it should be recorded in the minutes of the committee meeting that an agreement regarding confidentiality was reached.

An example of a creditors' committee confidentiality agreement is attached as Exhibit "A".

III. Debtors and Confidentiality Agreements

Getting meaningful information is the first step to adequately representing unsecured creditors' rights. The official committee of unsecured creditors more often than not will require financial information from the debtor, or debtor-in-possession, to make informed decisions regarding the use of cash collateral, potential litigation, objections to claims, objecting to the plan of reorganization, and the distribution to the unsecured creditors.

There are numerous means to obtain meaningful financial information from a business in bankruptcy. The debtor has a duty to provide the following basic financial information: a complete list of creditors; a schedule of all of assets and liabilities; a schedule of current income and expenditures; a schedule of all executory contracts; and a statement of financial affairs. The debtor must also file monthly operating reports.

More detailed information may be obtained either consensually or by compelling a debtor, its officers, employees, or accounting professionals to testify in an examination under oath Rule 2004 of the Bankruptcy Code. In both circumstances the committee may be required to enter into a confidentiality agreement before being permitted access to the confidential, non-public financial information.

An example of a confidentiality agreement a debtor may require a committee to enter into is attached as Exhibit "B".

IV. Conclusion

A well crafted confidentiality agreement will allow the sharing of confidential information while ensuring it does not end up in the hands of third parties.

EXHIBIT "A"

CONFIDENTIALITY AGREEMENT

BY AND BETWEEN THE MEMBERS OF THE COMMITTEE OF UNSECURED CREDITORS

This Confidentiality Agreement ("Agreement") is made and effective January 1, 2005, by and between each individual member of the Official Committee of Unsecured Creditors (the "Committee Members").

1. **Confidential Information**.

The Committee Members propose to disclose certain confidential and proprietary information (the "Confidential Information") during the deliberations of the Unofficial Committee of Unsecured Creditors (the "Committee"). Confidential Information shall include all data, materials, products, technology, computer programs, specifications, manuals, business plans, software, marketing plans, business plans, financial information, all communications other information disclosed or submitted, orally, in writing, or by any other media, to the Committee by the Committee Members.

(Continued on page 9)

CONFIDENTIAL INFORMATION AND CONFIDENTIALITY AGREEMENTS?

(Continued from page 8)

2. **The Committee's Obligations**.

A. The Committee Members agree that the Confidential Information is to be considered confidential and proprietary to the Committee Members and shall hold the same in confidence, shall not use the Confidential Information other than for the purposes of its business with the Committee, and shall disclose it only to the Committee's appointed counsel. The Committee Members will not disclose, publish or otherwise reveal any of the Confidential Information received from the Committee Members to any other party whatsoever except with the specific prior written authorization of the Committee.

B. Confidential Information furnished in tangible form shall not be duplicated by the Committee Members or the Committee except for purposes of this Agreement. Upon the request of the Committee Members, the Committee shall return all Confidential Information received in written or tangible form, including copies, or reproductions or other media containing such Confidential Information, within ten (10) days of such request. At the Committee Members option, any documents or other media developed by the Committee containing Confidential Information may be destroyed by the Committee. The Committee shall provide a written certificate to the Committee Members regarding destruction within ten (10) days thereafter.

3. **Term**.

The obligations of the Committee Members herein shall be effective from the date the Committee is formed until the date the post-confirmation committee is formed. For any further protection of confidential information post-confirmation, an additional agreement must be executed.

In the event a post-confirmation committee is not formed, this Agreement shall terminate upon the confirmation of the plan of reorganization or liquidation.

All Confidential Information shall be returned to the Committee Members or filed with the Committee's counsel within (10) days of the termination of this Agreement.

4. **Other Information**.

The Committee Members shall have no obligation under this Agreement with respect to Confidential Information which is or becomes publicly available without breach of this Agreement by the Committee or the Committee Members; is rightfully received by the Committee or Committee Members without obligations of confidentiality; or is developed by the Committee or the Committee Members without breach of this Agreement; provided, however, such Confidential Information shall not be disclosed.

5. **No Publicity**.

The Committee Members agree not to disclose its participation in this undertaking, the existence or terms and conditions of the Agreement, or the fact that discussions are being held with the Committee.

6. **Governing Law and Equitable Relief.**

This Agreement shall be governed and construed in accordance with the laws of the United States and the State of **California** and the Committee Members consent to the exclusive jurisdiction of the state courts and U.S. federal courts located there for any dispute arising out of this Agreement. The Committee Members agree that in the event of any breach or threatened breach by one of the Committee Members, the Committee Members may obtain, in addition to any other legal remedies which may be available, such equitable relief as may be necessary to protect the Committee Members against any such breach or threatened breach.

7. **Final Agreement**.

This Agreement terminates and supersedes all prior understandings or agreements on the subject matter hereof. This Agreement may be modified only by a further writing that is duly executed by all parties.

8. **No Assignment**.

The Committee Members may not assign this Agreement or any interest herein without the Committee Members express prior written consent.

9. **Severability**.

If any term of this Agreement is held by a court of competent jurisdiction to be invalid or unenforceable, then this Agreement, including all of the remaining terms, will remain in full force and effect as if such invalid or unenforceable term had never been included.

10. **Notices**.

Any notice required by this Agreement or given in connection with it, shall be in writing and shall be given to the appropriate party by personal delivery or by certified mail, postage prepaid, or recognized overnight delivery services.

Committee Members:

_____

[Member]
[Member's Title and Address]

_____

[Member]
[Member's Title and Address]

_____

[Member]
[Member's Title and Address]

_____

[Member]
[Member's Title and Address]

_____

[Counsel for the Committee]
[Counsel's Address]

11. **No Implied Waiver.**

The Committee Members failure to insist in any one or more instances upon strict performance by the other parties of any of the terms of this Agreement shall not be construed as a waiver of any continuing or subsequent failure to perform or delay in performance of any term hereof.

12. **Headings**.

Headings used in this Agreement are provided for convenience only and shall not be used to construe meaning or intent.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

_____

[Member]
[Member's Title and Address]

(Continued on page 10)

CONFIDENTIAL INFORMATION AND CONFIDENTIALITY AGREEMENTS?

(Continued from page 9)

_____

[Member]
[Member's Title and Address]

_____

[Member]
[Member's Title and Address]

_____

[Counsel for the Committee]
[Counsel's Address]

EXHIBIT "B"

DEBTOR'S CONFIDENTIALITY AGREEMENT TO RELEASE OF FINANCIAL INFORMATION TO THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS

WHEREAS, The United States Federal Government; Department of Defense (DOD); Department of Transportation (DOT), (the "Bankruptcy Cases"), which are being jointly administered pursuant to Federal Rule of Bankruptcy Procedure 1015(b) and the bankruptcy court order dated January 1, 2005; and

WHEREAS, the United States Trustee appointed an official committee of creditors to represent unsecured claimants under the Bankruptcy Cases (the "Official Committee of Unsecured Creditors" or the "Committee"); and

WHEREAS, the Debtors are prepared to furnish the Committee with certain confidential and proprietary information relating to the Debtors' business affairs, including contracts, documents, plans, analyses, customer lists and other financial information, including but not limited to, prospective buyers of the Debtors' business affairs, subject to the terms of this Confidentiality Agreement (the "Agreement").

NOW, THEREFORE, the Committee and its Representatives (as defined below) agree as follows:

1. The Debtors shall designate as "Confidential" or "Restricted" or otherwise identify in writing any material, documents or writings that are intended to be subject to the provisions of this Agreement. In addition, all oral communications by representatives of the Debtors to the Committee or its Representatives intended to be subject to the protection of this Agreement related to the Debtors' customers, contracts, proposals, prospective buyers and business affairs shall be designated as such by the Debtors and shall be presumed to be protected by this Agreement. Except as provided below, all such information, whether disclosed or communicated to the Committee or its Representatives verbally or in writing, is herein collectively referred to as "Confidential Information" and shall be subject to the protection of this Agreement unless otherwise agreed in writing by the Debtor. The term "Confidential Material" shall not include, and this Agreement shall be inoperative, as to any information which, (i) is generally available to the public other than as a result of disclosure by the Committee or its Representatives (as defined below), (ii) was in the possession of the Committee or its Representatives prior to its disclosure by the Debtor, or (iii) was in the possession of the Committee or its Representatives on a non-confidential basis prior to disclosure by the Debtors, provided such information was not obtained or disclosed in violation of a confidentiality agreement, law or other restriction providing for the confidentiality of such information.

2. Subject to the provisions of Paragraph 1 above, the Committee and its Representatives acknowledge and agree that all Confidential Material shall remain confidential. Accordingly, the Committee and its Representatives agree that prior to the Committee or any of its members, attorneys, experts, partners, agents, employees, advisors, consultants or other representatives (collectively, "Representatives") being given access to the Confidential Material, each such Representative shall execute and agree to be bound by the terms of this Agreement. The Committee shall immediately notify in writing counsel for the Debtors of each person who signs this Agreement and is provided Confidential Material.

3. To maintain the confidentiality of the Confidential Material, the Committee and each Representative agree:

(a) Not to use or allow the use for any purpose of any Confidential Material or notes, summaries, memoranda, analysis, studies, extracts or other materials or documents based on, containing, derived from, or otherwise reflecting the Confidential Material (collectively, "Notes") other than in connection with legal proceedings and the satisfaction of the Committee's duties in the Bankruptcy Cases. Any Confidential Material or Notes, any testimony related to, referring to, based on, or derived from the Confidential Material or Notes, and any papers, pleadings, documents, or exhibits related to or pertaining to, based on, containing or otherwise reflecting the Confidential Material or Notes, if filed with the Court by the Committee or its Representatives, shall be filed under seal. If the Committee or its Representatives determine that it is necessary to disclose Confidential Material or Notes in open Court, they shall not use or disseminate any such Confidential Material or Notes without prior notice to the Debtors so that the Debtors may determine whether it is necessary for the Debtors to request a hearing for appropriate protective measures to prevent the public disclosure of the Confidential Material or Notes. At any such hearing, the Committee and its Representatives will join in any request by the Debtors that Confidential Material or Notes shall be held in a confidential manner and not disclosed to third parties without prejudice to their rights to argue that any such information is not Confidential Material or Notes.

(b) Not to disclose or allow disclosure to others of any Confidential Material or Notes except to Representatives who have signed this Agreement and, then, in each case, only to the extent necessary to permit such Representative to assist in advising the Committee; and

(c) Not to communicate directly or indirectly with any potential bidders, creditors, buyers, customers, competitors of the Debtors, the media or any other third person concerning any past, present or future aspects of the Confidential Material or Notes.

4. As long as the Bankruptcy Cases

(Continued on page 11)

CONFIDENTIAL INFORMATION AND CONFIDENTIALITY AGREEMENTS?

(*Continued from page 10*)

are on the active docket of the Court, if the Committee or its Representatives are requested or required (by oral questions, interrogatories, requests for information or documents, subpoena, civil investigative demand or similar process) to disclose any Confidential Material or Notes, the Committee and its Representatives agree to seek a protective order solely based on the existence of the terms and conditions of this Agreement and also to provide the Debtors with prompt written notice of such request (s) so that the Debtors may also seek an appropriate protective order. If, failing the entry of a protective order, the Committee or its Representatives are compelled to disclose Confidential Material or Notes under pain of liability for contempt or other penalty, the Committee or its Representatives, as the case may be, shall disclose only that portion of the Confidential Material or Notes which is legally required to be disclosed. If the Bankruptcy Cases are closed, the Committee and its Representatives shall immediately notify the Debtors in writing of such a request for information or documents and the Debtors shall take any steps necessary to protect its interest in the confidentiality of the Confidential Material or Notes.

5. This Agreement is not assignable by the Committee or its Representatives and shall be binding upon the Committee and its Representatives and any successors thereto and shall survive the conclusion of the Bankruptcy Cases.

6. It is agreed that no failure or delay by the Debtors in exercising any right, power or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise thereof preclude any other or future exercise thereof or the exercise of any other right, power or privilege hereunder. Nothing contained herein shall restrict the use by the Debtor of Confidential Materials or Notes or limit or preclude the Debtors from raising objections to the production or disclosure of information or documents. Nothing contained herein shall prohibit the Committee from requesting the production or disclosure of information or documents in accordance with the Federal Rules of Civil Procedure, provided, however, that this Agreement shall apply with respect to any such request(s) and disclosure(s). Further, nothing contained herein shall prohibit the Committee or its Representatives from seeking relief in the Bankruptcy Court and/or raising objections from the designation of documents as Confidential Material or Notes in the Bankruptcy Cases.

7. This Agreement (i) shall be governed by and construed in accordance with the laws of the State of California, without giving effect to principles of conflicts of laws, (ii) may be amended, modified or supplemented only by a written instrument executed by each of the parties hereto, and (iii) constitutes the entire agreement with respect to the subject matter hereof and supersedes all prior or contemporaneous negotiations or agreements with respect thereto. If any one or more of the provisions contained in this Agreement shall for any reason be held invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provision of this Agreement, but this Agreement shall be construed as if such invalid, illegal or unenforceable provision had never been contained in it. Any dispute arising from or out of this Agreement shall be resolved in the Bankruptcy Court, and the Committee and its Representatives submit to personal jurisdiction of the Bankruptcy Court for such purpose.

8. This Agreement may be executed in counterparts and by facsimile signature, all of which together shall constitute one and the same agreement.

Accordingly, done and signed by the Committee and Representatives on the dates set forth hereinafter.

Official Committee of Unsecured Creditors
By its Members:

January 1, 2005

_____
By: Henry Ford
Ford Motor Co.

January 1, 2005

_____
By: Mike Smith
General Motors

CHECK 21 AND NSF CHECKS

(*Continued from page 3*)

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

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

Bad Check Laws And Check 21

Pre-Check 21 And Bad Check Law

Prior to passage of Check 21, if you received an NSF check, you typically didn't know it was bad until the bank returned it, often up to two weeks later. You could then redeposit the check with the bank. If the check did not clear, you could then send a demand letter to the customer. Of course, your risks were higher, as additional shipments could be made until you received notice from the bank of the NSF.

Post-Check 21 And Bad Check Law

Notification of NSF checks may change significantly post-Check 21. Post-Check 21, you may learn promptly of an NSF check because the float time is less and most banks will offer notice of NSF checks via email or on-line. Some banks may continue to mail notice of the NSF checks. Each bank may set up its standard for immediately notifying vendors of NSFs.

At this point, it appears that banks may set their own standards for the redeposit procedure, after the initial attempt fails. The bank may redeposit the check without returning the check to you, based on your instructions to them. Or, the bank may issue a substitute check stamped "Returned due to NSF" and return the check to you. The substitute check is the legal equivalent of the original, so you may use this for reporting to the police authorities.

Does The NSF Demand Letter Still Need To Be Sent?

Under most bad check statutes, you must send a demand letter to the customer requesting grounds for the check not clearing (such as stopping payment because of a quality of goods issue) for you to be entitled to treble damages.

Exhibit "A" is an example of this form of letter.

With Check 21, a customer likely will not have an opportunity to issue a stop payment as it will not have had an opportunity to inspect the goods prior to the check clearing. In most instances, because of the speed with which checks clear, when you receive an NSF check now, in the new "Check 21 environment," it won't be because of a customer protest. However, the bad check laws and demand letters have not yet changed as a result of Check 21.

Conclusion: Check 21 Will Make It Easier To Deal With The NSF Check

Check 21 better protects you from the risks of an NSF check, especially the typically lengthy time it takes to find out. As a result of image technology, you will receive notice of the NSF check and can take steps to protect your sale, as well as future orders the customer may desire to pay by check.

EXHIBIT "A"

[Date]

VIA CERTIFIED MAIL

[Buyer]

Re: Vendor v. Buyer

Dear *[Buyer]*:

[Vendor] is the payee of a check you wrote for *[$_____]*. The check was not paid because you stopped payment, and *[Vendor]* demands payment. You may have a good faith dispute as to whether you owe the full amount. If you do not have a good faith dispute with the *[Vendor]* and fail to pay the payee the full amount of the check in cash, a service charge of an amount not to exceed $25 for the first check passed of insufficient funds, and $35 for each subsequent check. You could be sued and held responsible to pay at least the following:

(1) The amount of the check;

(2) Damages of at least $100, or three times the amount of the check up to $1,500.

If the court determines that you have a good faith dispute, you will not have to pay the service charges and treble damages.

A DAY LATE AND HUNDREDS OF THOUSANDS OF DOLLARS SHORT: CALENDAR THOSE BAR DATE NOTICES!

(*Continued from page 4*)

Where the credit professional has failed to timely file a formal proof of claim, all may not be lost. Courts have permitted certain writings, filed before the bar date and furnishing the information that a formal proof of claim would provide, to serve as a proof of claim to avoid the harsh results of strict enforcement of a bar date. This court-made exception has been labeled the "informal" proof of claim. To constitute an informal proof of claim, courts generally require an explicit demand establishing the nature and amount of the claim against the debtor, and evidence of an intent to hold the estate liable.

The vendor meets the first part of the test with the presentation of writings, prior to the bar date, bringing to the attention of the court the nature and amount of the claim. With regard to the second part of the test, courts have deemed a variety of documents to express a creditor's intention to hold the estate liable and thus to constitute an informal proof of claim, including a letter with a balance sheet attached sent to the trustee, a letter with two tax bills sent to the trustee, invoices sent to the debtor on four occasions, an involuntary bankruptcy petition filed by a creditor, a complaint filed objecting to discharge and an objection filed opposing confirmation of the debtor's plan of reorganization.

On the other hand, conversations by a vendor with counsel for the creditors' committee, conversations between the debtor and counsel for a vendor, filing of a notice of appearance in the proceeding, and litigation in a non-bankruptcy forum have been found insufficient to constitute an informal proof of claim.

A timely filed informal proof of claim alone does not permit a vendor to participate in a distribution of proceeds with like claims. Rather, a timely filed informal claim must be amended by the filing of a formal proof of claim within a reasonable time after the bar date. The formal claim is deemed to relate back to the filing date of the informal claim. Amendments to claims are liberally allowed if the purpose of the amendment is to cure a defect in the claim. However, an amended claim seeking recovery on a new or different claim will be denied. An amendment changing the amount of the claim does not constitute an untimely attempt to assert a new or different claim.

Given the creditor's duty to file a proof of clam, two court decisions concerning missing a bar date are considered.

III. The Kmart Ruling and A Creditor's Excusable Neglect

Kmart filed Chapter 11, and established July 21, 2002 as the deadline for filing proofs of claim. (Original Bar Date). The bankruptcy court established a supplemental bar date of January 22, 2003 (Supplemental Bar Date) for a limited set of pre-petition date creditors who had not previously been sent notice of the Original Bar Date.

A person was injured in a Kmart store prior to Kmart's bankruptcy. The creditor asserted a claim against Kmart for $750,000. Notice of the Original Bar Date was sent to her address as listed in the files of Kmart. The creditor asserted that she never personally received the notice. The creditor's attorney had actual knowledge of the Original Bar Date, as counsel had filed timely proofs of claims for over two dozen other Kmart creditors.

The creditor's proof of claim was received by Kmart one day after. Kmart considered the claim late filed – although filed but one day after the bar date. The creditor requested the bankruptcy court allow the lat-filed claim be deemed timely filed.

Evaluating whether the creditor's late filing was the result of excusable neglect, the bankruptcy court considered four factors.

The bankruptcy court denied the creditor's request to deem the claim timely filed. The creditor again tried to avoid the effect of her late filing by moving to have her claim covered by the Supplemental Bar Date. The Court of Appeals for the seeks to determine if the bankruptcy court has abused its discretion.

Factor 1: Danger of Prejudice to Debtor

The bankruptcy court determined that allowing the creditor's claim would prejudice Kmart's creditors. The court noted that allowing similarly situated creditors could induce other late-claimants to so petition the bankruptcy court.

Factor 2: Length of the Delay and its Impact on Judicial

Proceedings

While the proof of claim was merely one day late, the creditor waited 81 days to file the motion to allow the late-filed claim. While the creditor did not realize that the claim was late until receiving a notice from Kmart 53 days after the Original Bar Date. However, the court observed that a bar date order is integral to Chapter 11.

> "A bar order serves the important purpose of enabling the parties to a bankruptcy case to identify with reasonable promptness the identity of those making claims against the bankruptcy estate and the general amount of the claims, a necessary step in achieving the goal of successful reorganization. If individual creditors were permitted to postpone indefinitely the effect of a bar order so long as adversary proceedings were pending, the institutional means of ensuring the sound administration of the bankruptcy estate would be undermined."

The Appellate Court concluded that the bankruptcy court's finding as to the length of delay and its concomitant negative impact on judicial proceedings was not clear error.

Factor 3: Reason for the Delay

The creditor stated that the reason for the delay was nothing more than an innocent mistake in mailing the claim. The court concluded this was a poor reason. The court observed that the creditor left the filing of the proof of clam until the latest possible time. The creditor could have taken measures to verify that the proof of claim arrived on time, but failed to do so. It was her own fault.

Factor 4: Creditor's Good Faith

The creditor waited to file her proof of claim until the "eleventh hour," and failed to follow up with the third-party claims processing agent.

(*Continued on page 14*)

A DAY LATE AND HUNDREDS OF THOUSANDS OF DOLLARS SHORT: CALENDAR THOSE BAR DATE NOTICES!

(Continued from page 13)

In summary, the Kmart decision reminds creditors that a court may not be willing to forgive the creditors for missing a bar date, even if only by a day.

IV. Another Court's View: Mail Your Claim On Time And To The Proper Party—Or Lose!

Outboard Marine filed bankruptcy. The notice of bar date required creditors to mail their proofs of claims to a claims' agent by a specific date. A creditor, who was owed $1.1 million, faxed its proof of claim on the trustee's counsel, but not on the claims agent, as set forth in the notice of bar date. The trustee objected to the claim as untimely, and the bankruptcy court sustained the objection.

The bankruptcy court appointed a claims agent because of the large number of proofs of claims that were to be filed and to streamline the process. The claims agent designated a post office box as the repository for all proofs of claim. The bar date notice specified the method of transmittal, and emphasized that the claims had to be received by the bar date and sent to the post office box. The bar date notice did not provide a fax number. The claims agent received more than 5,300 proofs of claim, valued at $3.5 billion.

On appeal, the creditor argued that it complied with the bar date by faxing its proof of claim to the claims agent on the bar date. The creditor also asserted that its faxed claim to the trustee should be deemed timely, and that its claim should be characterized as a timely-filed informal claim.

The Court of Appeals for the Seventh Circuit was not persuaded. The court noted the bar date notice only permitted one method of transmittal: claimants were required to mail proofs of claim to a designated post office box so that they would be received by the claims agent by the specified date. Instead of following the instructions contained in the bar date notice, the court observed, the creditor faxed its proof of claim to the trustee's counsel. The court found that the bankruptcy court did not error in finding that the creditor's eleventh hour fax was not timely filed.

The creditor also advanced two equitable arguments in an attempt to allow its claim. Under one argument, the creditor argued that Bankruptcy Rule 5005(c) allowed a bankruptcy court to backdate papers, such as a proof of claim, that are erroneously delivered to the wrong official in a bankruptcy proceeding. Second, the creditor asserted that its fax to the trustee amounted to an informal proof of claim because it stated the existence, nature, and amount of the claim, and because it evidenced the creditor's intent to hold the debtor liable for its debt. The appeals court rejected these arguments.

The appeals court determined that creditor failed to offer convincing justification or explanation for its untimely filing. The court observed that the creditor's problem was self inflicted. Although the creditor's claim of $1.1 million was a small fraction of the $3.5 billion in claims asserted against the bankruptcy estate, the court considered that it was not deminimis. If the creditor's mistake were accepted, the court reasoned, the efficient administration of the bankruptcy case would be upset. The appeals court upheld the lower courts, and the creditor's claim was disallowed.

Conclusion

The courts rulings impress on the credit executive that bar date notices should be immediately recorded, with reminders. As evidenced by the courts rulings here, courts are reluctant to upset the bar date filing deadline, especially where the creditor failed to act.

However, if you find the bar date has slipped by, and were required to file a proof of claim, review your files to determine whether you have provided documents that may be construed as an informal proof of claim. If you have provided documents filed or presented prior to the bar date that show the existence of a claim against the debtor, and these documents demonstrate an intention to hold the estate liable, you may be able to establish an informal proof of claim to support amendment with a formal claim.

RELEASE OF INCOHOATE LIEN: DEFENSE TO RECOVER ALLEGED PREFERENTIAL TRANSFER?

(*Continued from page 1*)

creditor contended that is was a secured creditor and thus the transfer did not enable it to receive more than under a chapter 7, thus there is no avoidable preference.

In a chapter 7 liquidation case, if a creditor is fully secured, it should receive the full value of its claim. In order to determine if a creditor is fully secured the court must determine if the value of assets secured as collateral equaled or exceeded the value of the creditor's secured claim. In order to determine the secured status and value of a creditor's interest in the debtor's property on the transfer date, the court must look to state law.

In *Golfview Development Center*, the court applied Illinois law. An Illinois mechanics lien is a statutory lien, and the lien extends to all interests that the owner has in the property improved by the lien claimant. The court found that the requirements of a valid inchoate mechanics lien had been met: (1) the debtor and creditor had a valid contract; (2) the landlord, pursuant to the lease with the debtor, knowingly permitted the debtor to make improvements on the property; (3) the creditor furnished lienable materials and labor; (4) the creditor did in fact perform under the contract.

The creditor was paid within two months of completion of the work, and thus had no need to give written notice or record a verified claim for lien, or file suit to enforce and foreclose its mechanics lien. The debtor argued that because the creditor did not perfect its lien rights, it released any secured status it had. The court disagreed with this argument finding that the creditor's claim was secured to the extent of its inchoate lien. Section 101(37) of the Bankruptcy Code defines lien as a charge against or interest in property to secure payments of a debtor or performance of an obligation. The legislative history of §101(37) makes clear that the term lien includes inchoate liens.

The court found that at the time of the transfer the creditor was a secured creditor by the full amount of the worth of work it had performed for and materials supplied to the debtor. Accordingly, the court found that the transfer was not a preference under section 547 of the bankruptcy code and was therefore not recoverable. The *Golfview Development Center* case may offer sanctuary to the construction creditor that releases its lien rights after payment, provided it is a fully secured creditor of the debtor.

A VENDOR'S RIGHT TO A POSSESSORY LIEN

(*Continued from page 2*)

tate; any act to create, perfect, or enforce any lien against property of the estate; any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title; and any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.

The purpose of the stay is to give the debtor a breathing spell from its creditors, and to stop all collection efforts, harassment and foreclosure actions. With respect to possessory liens, the Stay also protects creditors as a class from the possibility that one creditor will obtain payment on its claims to the detriment of other creditors. Bankruptcy courts have held that a creditor's good faith belief that it had a right to the property is not relevant to whether the act was willful or whether damages must be imposed for violating the Stay.

In a recent bankruptcy case, *In re Midway Airlines, Inc.*, 2004 WL 2029315 (7th Cir.), the court considered a vendor's right to a possessory lien. In the *Midway Airlines* case, a vendor that had managed a chapter 7 debtor-airline's fuel tank storage facility and had supplied airport fueling services for the debtor's aircraft failed to establish that a bailment ever took place. A bailment is the relationship that arises where one delivers property to another to keep for hire, and control and possession passes to the bailee (i.e., the entity holding the property). No bailment of the debtor's jet fuel was created by virtue of the vendor's possession and control over the debtor's tank farm as the vendor neither owned nor leased the fuel tanks. The vendor's role with respect to the tanks was that of an agent. The vendor was not able to assert a possessory lien as there was no delivery of goods into the vendor's possession. Accordingly, under Illinois law, the vendor was not entitled to a possessory lien for services in the proceeds from the sale of the debtor's jet fuel inventory because lawful possession was not established.

To review, under U.C.C. § 9-333, a possessory lien is an interest that secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person's business, that is created by statute or rule of law in favor of the person, and the effectiveness of which depends on the person's possession of the goods. A possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise.

Any vendor, while lawfully in possession of personal property, who renders any service to the owner thereof, may assert a possessory lien, for the compensation, which is due to the vendor from the owner for such service.

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Winter 2004

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

- ◊ Scott spoke to **Brighton Industries** for an In-house discussion regarding **credit applications.**
- ◊ Scott spoke to **CMAC/CFDD** regarding **Sarbanes Oxley**.
- ◊ Scott spoke at the **BPCA Credit Conference** regarding **Check 21.**
- ◊ Scott spoke at the **New England Credit Conference** in Rhode Island regarding **Creditors' Rights.**
- ◊ Scott spoke to **NACM/Tampa** in Phoenix regarding **Sarbanes Oxley.**
- ◊ Scott spoke to the **National Association of Realtors** in Las Vegas regarding **Creditors' Rights.**
- ◊ Scott spoke to the **National Hardwoods Group** in Las Vegas regarding **Creditors' Rights.**
- ◊ Scott spoke to the **NACM/National Staffing Group** regarding **What's Hot with Payment by Check.**
- ◊ Scott spoke to **NACM/Connecticut** in Las Vegas regarding **What's Hot with Payment by Check.**
- ◊ Scott spoke to **NACM/Tampa's** industry group in Las Vegas regarding **Sarbanes Oxley.**
- ◊ Scott spoke to **What's Working in Credit and Collections members** regarding **What's Hot with Payment by Check.**
- ◊ Scott spoke to **NACM/Connecticut's Fine Paper Industry Group** in San Diego regarding **What's Hot with Payment by Check.**
- ◊ Scott spoke to **Credit Research Foundation** and **IOMA's** members regarding **Recent Developments with the Critical Vendor.**

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