Blakeley & Blakeley LLP

THE TRADE VENDOR QUARTERLY

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

BATTLE FOR THE PROCEEDS: PREVAILING ON YOUR PURCHASE MONEY SECURITY INTEREST, DESPITE POST-DATED CHECK

Scott Blakeley

A Purchase Money Security Interest (PMSI) is the most common kind of secured financing. A vendor may find effective protection in a PMSI when selling on credit to a debtor that could be financially shaky. The PMSI may provide additional assurance of payment that permits the sale. This protection is complete only when the PMSI has been perfected in a multi-step process provided for by Article 9 of the Uniform Commercial Code (UCC).

Perfecting a PMSI can be especially tricky when the debtor has an existing inventory-secured creditor. A creditor perfects is security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the collateral. The creditor takes priority over any unsecured creditors, and has the right to take possession and sell the collateral if the debtor defaults.

Where there is a pre-existing inventory-secured creditor, Article 9 of the UCC imposes additional conditions, or perfection requirements, with which the vendor must comply. If a vendor obtains a lien against the debtor, any failure of the vendor's to strictly comply with the perfection requirements of Article 9 could provide cause for the lien to be challenged. A battle for the proceeds will ensue.

In *Sony Corp. of America v. Bank One (The Stereo Factory)*[1] the court considered whether the vendor had a first-priority claim in the proceeds from sale of its merchandise, and whether the vendor could trace the proceeds of the inventory. Thus, the vendor faced two battles for the proceeds: first, to establish that it had complied with the perfection requirements of Article 9; and second, to trace the proceeds from the sale of inventory.

The Sales And PMSI

The debtor, Stereo Factory, was a wholesale distributor of stereo and consumer goods. To finance its operations, the debtor obtained loans from a bank. In exchange for the financing, the debtor granted the bank a security interest in virtually all of its assets, including inventory and accounts receivable. The bank properly perfected its security interests. Thereafter, a vendor, Sony Corporation, extended credit to the debtor for the purchase of its merchandise. The debtor granted the vendor a PMSI in the merchandise, as well as payment. The vendor notified the secured creditors (including the bank) of its PMSI in the inventory.

The debtor submitted to the vendor a purchase order for one million cassette tapes, at $.55 per tape. The debtor made a $160,000 down payment. The vendor made a total of three shipments of the tapes. After the first two shipments to the debtor were made, the debtor forwarded the tapes to retailers who paid the debtor by check the same day.

When the vendor shipped the remaining 500,000 tapes, together with an invoice of $275,000, to the debtor, the debtor also forwarded these tapes to a retailer. The retailer received the tapes from the debtor on September 3. The retailer deducted $20,000 from the invoice price, for paying in cash within three days of receipt and issued a check to the debtor the following day, on September 4. The debtor deposited the check into its account on September 8.

Although the debtor received full payment from its retailers, it did not pay the vendor for the tapes other than the down payment of $160,000. Subsequently, the debtor sold part of its operations for $250,000 and deposited the proceeds from the sale of its operations into a checking account. The debtor also opened a savings account pledged to the bank to secure its outstanding loans. The debtor transferred $78,000 from its checking account into the savings account. The debtor also

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UCC SEARCHES IN THE COMPUTER AGE

Scott Blakeley

As in most businesses, the introduction of computer technology has revolutionized the credit field. Access to seemingly limitless information and reporting is now available on a credit executive's desktop.

One example of how computer databases are used is in a lien search. For a business considering extending credit to a potential debtor, lien searches are very important as the search discloses the number and type of secured creditors the debtor has. This information may be used by the credit executive for cash flow and liquidation analysis of the debtor and could provide a compelling picture of the risk of extending credit.

While computers cut down on the time it takes a conduct a lien search, their efficiency may also create certain risks for credit executives. Uncovering a lien has everything to do with how that lien was recorded. A database (computerized) search of the debtor's name will not uncover liens that have been improperly recorded. Here's why: if a creditor who has filed a lien failed to properly record the debtor's name, the lien will not show up in a database search by the debtor's correct name to the exact input it is given. This is not such a widespread problem in manual searches because the person doing the manual search also checks for basic variations of the debtor's name.

In *In re Mines Tire Co., Inc.*[1], the debtor's name was not properly recorded so the court had to consider whether or not a lien should stand. A database search had not uncovered the lien, yet the lien was uncovered in a manual search. Under Article 9 of the Uniform Commercial Code, courts generally allow liens to stand where the secured creditor's mistake in recording the debtor's name is not seriously misleading to anyone conducting a search. This court's analysis, accordingly, provides a warning to credit executives that computerized searches may not be thorough enough, in case a creditor has failed to properly record the debtor's name.

Selling The Business

In *Mines Tire Company*, a tire center sold its business to the debtor, Mines Tire Company. Mines Tire Company executed three promissory notes to favor of the seller. The notes were supposedly secured by all of Mines Tire Company's newly purchased assets. The seller filed a financing statement in the name of "Mines Company, Inc.", leaving out the word "Tire." Thereafter, Mines Tire Company filed a Chapter 11 bankruptcy, which was later converted to Chapter 7.

The seller sought to foreclose on the collateral. The Chapter 7 trustee objected on behalf of the unsecured creditors involved in the case. The trustee contended that the seller had not properly perfected its lien because the seller failed to include the word "Tire" in its financing statement. A computer search by the trustee under the name "Mines Tire Company" did not reveal any lien in favor of the seller. The trustee contended it could avoid the seller's lien under the Bankruptcy Code's "strong arm" avoiding powers.

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FROM THE PUBLISHER:

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

Guest Column

MECHANIC'S LIEN AS A DEFENSE TO A PREFERENCE ACTION?

Doug Fox [1]

One day in May, I was asked by another division (Division) to resolve payment problems with ABC company which was seriously past due on $135,000. ABC was providing a $400,000 machine to be installed in a $100,000,000 manufacturing facility located in the Midwest.

Although Division had already shipped its product to ABC, ABC had not shipped the end product to Midwest -- which owed the last two progress payments to ABC. ABC had notified Division that it required an informal workout arrangement with its unsecured creditors in order to continue to stay in business.

Unknown to Division, ABC convened a meeting of what it claimed were the largest unsecured creditors. ABC told the unofficial committee that if the informal workout was not approved, then ABC would have no alternative but to file bankruptcy -- the result being that the secured creditor (i.e. the bank) would take all the assets of the company, leaving nothing for unsecured creditors.

The settlement included three options of an immediate payment ranging from 10 cents on the dollar to 33 1/3 cents on the dollar, followed by monthly payment over **four years**. The analysis assumed monthly contributions by the debtor out of positive working capital and profitable operations during the following four years. If successful, the total amount of the payments would result in 61 cents on the dollar.

Although the debtor told our company that the creditors committee had voted to accept the informal workout, our company refused to go along. Later, we learned that the debtor was lying about the acceptance of the plan by the creditors' committee -- and that Division's claim was larger than

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MARSHALING ASSETS: FORCING A SECURED CREDITOR TO GET PAID FROM THE GUARANTOR

Scott Blakeley

Your customer has filed a Chapter 7 bankruptcy. Is there an opportunity to receive payment - perhaps a significant payment - on your unsecured claim, even though a secured creditor asserts a security interest in all the debtor's assets?

Historically, Chapter 7's (the liquidation chapter of the Bankruptcy Code) yield little or no distribution to unsecured creditors as the secured creditor forecloses on the debtor's assets.

In a closely held corporation, it is common for the bank providing the financing to obtain a secured personal guarantee from the principal or principals of the corporate debtor. In some instances, the principals may have significant personal wealth. The concept of a guarantee, from the bank's perspective, is to create a second fund (after that of the corporate debtor) to satisfy the obligation, and that second fund is the principal.

In *In re Pietsch* [1], the court considered the common bankruptcy situation of a secured creditor (the bank) having two funds from which to recover, the corporate debtor and the principal by virtue of a guarantee. The unsecured (junior) creditors, however, had only the corporate debtor to recover from and that corporate debtor was insolvent. The unsecured creditors faced the prospect of having no distribution on their claims if the bank foreclosed on the corporate assets.

The Chapter 7 trustee, on behalf of unsecured creditors of the corporate debtor, requested the court to apply the marshaling doctrine. Marshaling requires a senior secured creditor who has recourse to two funds of the debtor as collateral to first resort to the fund which will not defeat the interests of the creditors with a junior position. In *In re Pietsch*, the bank must first look to the personal guarantee of the principals to satisfy its claim. The court's opinion and the marshaling doctrine are considered below.

The Two Fund Creditor And An Insolvent Corporate Debtor

The debtor company filed for Chapter 11 which later was converted to Chapter 7. A bank had provided secured financing to the debtor. The bank held a security a security interest in all of the debtor company's assets, including some real estate. The bank also provided financing to the debtor's principals. The security for this financing included two large parcels of real estate. As part of a forbearance agreement between the bank and the principals, the loans of the company and the principals were cross-collateralized. The Chapter 7 sold some of the debtor company's assets, and proceeds from that sale resulted in a substantial sale proceeds account.

The bank filed a motion with the bankruptcy court seeking to foreclose on the debtor company's sale proceeds account. There was an objection from the Chapter 7 trustee on behalf of the unsecured creditors in case. The Chapter 7 trustee contended that the bank's secured claim could be satisfied out of non-debtor assets (the real estate encumbered by the guarantee). According to the trustee, the appraised value of the principals' real estate provided sufficient equity to satisfy the bank's secured claim in full. If the court were to apply the marshaling doctrine, it could order the bank to first satisfy its secured claim from the principals' assets. The debtor company would then have sufficient assets to satisfy the claims of its unsecured creditors.

The bank objected that the marshaling doctrine be applied, saying the elements of marshaling could be met. The bank also said significant environmental problems with the principals' real estate existed that dramatically decreased its value.

The Marshaling Doctrine

The principle of marshaling is to promote fair dealing and justice. Marshaling is most commonly applied to prevent a junior lienholder with a security interest in one property from being squeezed out by a senior lienholder with a security interest in that and other properties. Marshaling is a doctrine reserved for junior lienholders, or, in certain jurisdictions, bankruptcy trustees. Marshaling "rests upon the principle that a creditor having two funds to satisfy his debt, may not by his application of them to his demand, defeat another creditor, who may resort to only one of the funds."[2]

The elements of marshaling are:(1) the existence of two creditors of the same debtor; and (2) the existence of two funds belonging to the same debtor; with (3) only one of the creditors having access to both funds; and with (4) the absence of prejudice to the senior secured creditor if the doctrine is applied. These elements are embodied by statute in some states, such as California. The junior creditor has the burden of establishing the elements.

Commonly, it is a junior creditor that moves to compel a senior creditor to marshal assets. Some bankruptcy courts recognize that a Chapter 7 trustee, acting on behalf of unsecured creditors, may request the court to order the secured creditor to marshal assets under the trustee's "strong arm" powers. These powers permit a trustee to assume the position of a hypothetical creditor to protect the collective interests of unsecured creditors. In this instance, the trustee used his strong arm powers as a hypothetical junior secured creditor of the debtor company. The court considered the traditional four elements of the marshaling doctrine.

Two Creditors Of The Same Debtor

The two sets of creditors against the company debtor were (1) the bank, and (2) the unsecured creditors, with the trustee acting on behalf of the unsecured creditors.

Two Funds Belonging To A Common Debtor

The bank contended that there was no common debtor simply by virtue of the personal guarantee, and the marshaling doctrine may not be applied. The court acknowledged the general rule of a common debtor when an individual guarantees

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PROMISES, PROMISES?. . . LENDER'S LETTER EXPRESSED INTENT BUT NOT PROMISE TO PAY VENDOR

Scott Blakeley

The last ten years have seen dramatic growth in the number of investment companies that specialize in turning around poorly performing companies. These investment companies are sometimes referred to as turnaround lenders. The turnaround lender's services usually range from advising the struggling company on ways to mange its cash flow, to serving as a lender, to buying the company's trade claims, to assuming responsibility for the company's accounts receivables.

In a poorly performing company, the arrival of a turnaround lender is usually good news for the credit executive. If the credit executive has been struggling to get timely payment on shipments, for example, a new lender may lead to the opportunity to bring current a delinquent account. For suppliers or vendors to the company, however, turnaround lenders may not represent an entirely positive development. These turnaround lenders often look to vendors to "share the pain" of a turnaround, which may mean vendors discounting their claims.

When a turnaround lender first identifies a target, it may circulate a letter to vendors expressing its interest in the target company. Such a letter would state that the troubled company has the financial wherewithal to work through its difficulties with the assistance of the turnaround lenders. These initial letters to vendors take many forms but the intent in sending them is usually to restore vendor confidence and to reopen shipments of merchandise on credit. Such a letter is an expression of intent by turnaround lenders to involve themselves in a company's affairs, but not necessarily more than that. It may not be a binding contract than a binding contract with the company--or its vendors.

The court, in *Carolina Cable & Connectors v. R&E Electronics, Inc.*[1] recently considered whether a proposed lender's letter to a vendor of a struggling company created a binding contract in which the lender was responsible for the vendor's open account, or whether the letter was a mere expression of intent that did not bind the turnaround lender.

A Promise To Pay?

The debtor, a small electronics manufacturer, purchased electronic components on open account from a vendor. The debtor failed to pay. As the vendor prepared to sue the debtor for the open account balance, it received a letter from a turnaround lender stating that the debtor and the lender had entered into an agreement to provide financing and advisory services. The letter stated:

> "As you have been made aware, [the lender] has entered into an agreement with your customer, R&E Electronics, to provide financing and various advisory functions. Through this arrangement, [the lender]'s goal is to see R&E Electronics expand its growth without realizing the cash-flow problems that naturally come with the expansion of any company.
>
> An essential ingredient to the success of R&E Electronics through this transition is to continue its relationship with its solid vendor base. R&E has greatly benefitted from its relationship with you as a supplier and we want that to continue. Our expectations in the short term are to bring our account to current status and to maintain those terms. Our long-term goals are to grow by using you as one of key suppliers and to soon be in a position to pay invoices early and take advantage of discounts.
>
> [the lender] saw R&E as a firm that has the capabilities to become one of the nation's largest providers of various telecommunications and electronics services. [the lender] will be the support vehicle to make that vision a reality.
>
> We appreciate your past support. [the

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OBTAINING RELIABLE INFORMATION ON A NEW ACCOUNT MAY NOT INCLUDE RELYING ON BANK'S COMMENTS ABOUT DEBTOR'S FINANCES

Scott Blakeley

For a credit executive determining whether to extend credit to a new account, obtaining *reliable* financial information is key. Information may be gleaned from a number of public and private sources. The credit executive may go directly to the debtor and request financial information, such as recent balance sheets, income statements and changes in financial position, and credit references. The credit executive may consult with members of his or her credit industry group, or vendors of the debtor not provided as references. Dun & Bradstreet may also provide useful background information. If the debtor is a public company, 10K's and 10Q's may also helpful. Companies such as Dow Jones may also provide meaningful current reports on the debtor.

The credit executive may also contact the lender to the debtor for a credit reference. Suppose the loan officer managing the debtor's account provides the credit executive verbal comments regarding his or her belief the bank's line of credit to the debtor is sufficient to cover the vendor's open account sales to the debtor. If you were the credit executive in this situation would you rely primarily on this information in basing your decision to extend credit to a new account?

In *FMC Corp. v. Fleet Bank*[1], a vendor faced such a situation and sold on open account based on the loan officer's statements. The debtor failed to pay. The vendor sued the debtor for breach of contract for failing to pay on the open account. The vendor also sued the bank for fraud and negligent misrepresentation. The vendor apparently was looking for a deeper pocket by suing the bank. The court's ruling is

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LEAVING MORE ON THE TABLE FOR UNSECURED CREDITORS IN BANKRUPTCY: CHANGING THE ABSOLUTE PRIORITY OF SECURED CLAIMS

Scott Blakeley

As vendors are well aware, bankruptcies seem intended to protect every constituency but theirs -- from the debtor's owners to attorneys and consultants to secured creditors. Because of the priority scheme imposed under state law and the Bankruptcy Code, vendors are expected to "share the pain" of a bankruptcy, while secured creditors, it seems, are made whole by virtue of their security interest in the debtor's collateral.

Vendors' claims are subordinate to secured creditors, which means these vendors have a right only to those assets that remain after secured creditors (and priority creditors) are paid. In a Chapter 11 bankruptcy, vendors are often forced to substitute their unsecured claims for stock in the debtor, which often is of speculative value. In a Chapter 7, often vendors simply receive a notice from the trustee stating there are no assets. The secured creditor has taken all of the assets. What's a vendor to do?

In *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*,[1] a recently published law review article, two law professors propose that giving full priority to secured creditors prior to payment of unsecured creditors creates unfairness and inefficiency in bankruptcies. The authors propose that Congress should consider rewriting the Bankruptcy Code to adopt a partial-priority rule wherein secured creditors receive payment only on a portion of their secured claim (e.g. 75%) and the balance is scheduled as unsecured. Under a partial-priority payment scheme unsecured creditors would at least receive a distribution on their claims.

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RESTITUTION REVISITED

Scott Blakeley

Consider the following common situation. Suppose you ship merchandise to a debtor on open account. The debtor defaults on a financing agreement with its lender. The lender, as provided for in its security agreement, sells your merchandise located at the debtor's business to satisfy its secured claim. Under what circumstances may you have a cause of action against the lender to restore to you the value of your merchandise? A California Court of Appeal, in *Knox v. Phoenix Leasing Inc.*,[1] recently faced such an issue and found that the lender was not liable to the debtor's unsecured vendor because the lender did not encourage the vendor to ship merchandise to the debtor.

The appellate court suggests that when a vendor provides merchandise that preserves the value of the lender's collateral, the acceptance by the lender could be a basis for liability. However, the case does not close the door on a vendor's claim for restitution (e.g. restoring the value of the goods foreclosed upon to the vendor) against a debtor's lender. Finally, there are ways a vendor may protect its merchandise sold on credit from a debtor's lender and avoid the need to litigate.

The Lender Forecloses On The Vendor's Merchandise

The debtor, a winery, contracted for 200 wine barrels from a vendor. Thereafter, the winery entered into a financing agreement with a lender to purchase wine barrels. The lender took a security interest in the winery's assets, including collateral to be acquired by the debtor in the future--the so called "floating lien" that permits a lender to grab after-acquired property upon a debtor's default. The vendor was paid for the first of two wine barrel shipments. The winery defaulted on the financing agreement and the lender took possession of the barrels pursuant to a security agreement and included the barrels in the liquidation of the winery. The vendor sued the lender to recover the value of the barrels under a theory of restitution (or unjust enrichment). The trial court ruled in favor of the vendor and the lender, in turn, appealed.

Uniform Commercial Code Considerations

The appellate court looked first to the provisions of the Uniform Commercial Code to sort out the vendor's claim for restitution. Article 9 of the Uniform Commercial Code (UCC) governs the perfection and priority of competing creditors on personal property (property other than real estate). Obtaining secured status is a multi-step process. A debtor first executes a security agreement describing the property covered in favor of the creditor, which gives the creditor a security interest in that property.

A creditor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the collateral. The creditor thus takes priority over unsecured creditors, and has the right to take possession of and sell the collateral if the debtor defaults. The purpose of Article 9 is two-fold: (1) it establishes a scheme that provides maximum protection to the secured creditor who has followed its provisions; and (2) provides a predictable system of creditor priorities. The appellate court noted that a secured creditor is entitled to payment before a creditor who has not complied with Article 9.

Where The Lender Has Done Wrong

Notwithstanding the general rule that a lender should be immune from a vendor's claim of restitution where it complies with Article 9's provisions, the appellate court stated that restitution may be permitted in certain situations. Courts look to either inequitable conduct by the lender or the nature of the vendor's contribution to the collateral. Where a lender encourages transactions between the debtor and vendor and benefits from the merchandise, there may be an opportunity for the vendor to unwind the transaction. If the lender had an active hand in promoting a transaction that goes bad, courts reason that the lender should not escape when a vendor is left behind holding an empty bag. A vendor should have a claim that the lender was unjustly enriched in this situation.

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maintained a "sweep account" wherein the debtor would sweep funds maintained in the checking account into the sweep account to earn interest.

Without notice to the debtor or other creditors, the bank set off $123,000 from the sweep account and $78,000 from the savings account, totaling approximately $201,000. The set off funds were used to pay down the bank loans. The bank also seized other assets which were sold off to repay the bank's loans.

The vendor sued the debtor for the unpaid portion of the tapes shipped to the debtor. The vendor also sued the bank and sought recovery of the $201,000 set off by the bank. The vendor contended the $201,000 set off by the bank constituted the proceeds from collateral in which it maintained a PMSI, thereby giving it a first priority claim to these funds.

The lower court ruled in favor of the vendor. The bank appealed. The appellate court faced two issues: (1) whether the vendor as holder of the PMSI in the inventory of the debtor, had a first-priority claim in the proceeds even though the debtor received payment for the inventory on the day after the delivery of the goods for the buyer; and (2) whether the vendor could trace the proceeds of the inventory, given that the debtor had earmarked a deposit account as originating from another source.

The First Battle: Perfecting The PMSI Where There Is An Existing Secured Lender

The first battle for a vendor embroiled in a priority dispute in the same collateral is establishing compliance with the UCC. Article 9 of the UCC governs perfection of and priorities among conflicting security interests in the same personal property (property other than real estate, with certain exceptions). To obtain a valid PMSI in merchandise they sell, vendors must comply with a multi-step process. A debtor first executes a security agreement describing the merchandise covered in favor of the vendor, which gives the vendor a security interest in that merchandise. Second, the vendor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) which adequately describes the merchandise.

As in the case in *Stereo Factory*, a vendor must take special steps if it is claiming a PMSI in merchandise that will become inventory of the debtor and there is a preexisting inventory secured creditor. Article 9 addresses conflicts between PMSI and inventory financiers:

> "A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has **priority in identifiable cash proceeds received on or before the delivery of the inventory** of a buyer ..."(emphasis added).

The vendor's PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the debtor receives possession of the merchandise (there is no 10 day grace period for perfection as there is with other types of collateral); and (2) the vendor gives written notice to any other preexisting inventory secured creditor.

It is the vendor's responsibility to check the filing office to determine the parties that have filed financing statements covering inventory and after-acquired property for this notice. The written notice to the inventory secured creditor must state that the vendor is taking a PMSI in merchandise. The written notice describes the merchandise. The vendor who takes these steps to perfect its PMSI should be entitled to the identifiable cash proceeds from the sale of its merchandise.

If the vendor fails to perfect the PMSI, including giving the notice described above before the debtor receives possession of the collateral, the vendor's priority is governed by the "first to file" rule. This means that an inventory secured creditor will prime the vendor's PMSI.

The *Stereo Factory* court found that the vendor had properly notified the bank of its PMSI in the tapes. The court focused on whether the proceeds from the third shipment of tapes were delivered "on or before the delivery" of the tapes. The debtor delivered the tapes to the retailer on September 3. The retailer's check was dated September 4. The bank argued the payment was not made "on or before the delivery" because the debtor did not receive payment on the day of delivery. If the court determined the check was not made on or before the delivery of the cassettes, the vendor lost the proceeds to the bank on the sale of the third shipment.

The court analyzed the "payment on or before delivery" language contained in Article 9 and determined that the language was intended to distinguish between transactions in which the buyer paid in cash and transactions in which the buyer set up a credit arrangement. The court determined the retailer did not purchase the third shipment of tapes on credit.

It was inferred that the debtor and the retailer intended to transact in cash, as evidenced by the retailer's discount of the purchase price based on invoice terms of cash sales. Merely because the check was issued the day after the tapes were received did not imply a credit transaction, the court noted. It is commonplace for business delays of a few hours or overnight in processing a check the court observed, which does not indicate an intent to extend credit for that short period: "[P]ayment for the third shipment of tapes was **reasonably contemporaneous** with the delivery of the goods and constituted payment 'on delivery.'"

However, the court gave a sharp warning for vendors: any longer delay of payment by the retailer and the payment would not have been protected by the PMSI.

The Second Battle: Tracing The Proceeds

Even though the court determined the vendor had a valid PMSI in the inventory, the vendor still faced the battle to trace the proceeds from the sale of inventory. The debtor placed the retailer's check, $242,000, representing the proceeds from the purchase of the third shipment of tapes into its

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checking account. Within nine days the bank set off $123,000 from the debtor's checking account and $78,000 from its savings account. The bank argued that the money in the savings account was not identifiable cash proceeds from the sale of the third shipment of tapes. Article 9 requires the PMSI holder to identify its proceeds. In tracing PMSI proceeds, courts generally apply "intermediate balance rule" which the court defined:

> "[P]roceeds remain in the account as long as the account balance is equal to or greater than the amount of the proceeds deposited. The proceeds are 'identified' by presuming that they remain in the account even if other funds are paid out of the account . . . Under the rule, however, if the balance of the account dips below the amount of deposited proceeds, [the prior] security interest in the identifiable proceeds abates accordingly. This lower balance is not increased if, later, other funds of the debtor are deposited in the account . . ."[2]

In other words, the first money the debtor spends out of its account is its own, before it can spend money encumbered by a PMSI.

The debtor transferred the proceeds from the sale of the third shipment of tapes to its savings account. The next day the debtor transferred $78,000 to a checking account. Prior to making the transfer to the checking account, the debtor deposited $250,000, which represented the proceeds from the sale of its operations, to its checking account.

The debtor intended the $78,000 deposited into its checking account to come from the sale of its operations, and not from the sale of the tapes. The debtor earmarked the $78,000 check with the words that it originated from the sale of operations. The bank argued that by the debtor earmarking the check the funds lost their identity as proceeds from the sale of the tapes. The court rejected the argument.

Once the $250,000 check was deposited in the checking account and commingled with other funds, the proceeds lost their identity as originating from the sale of operations. The debtor could not make a notation on the check which would result in segregating these funds and overcoming the lowest intermediate balance rule. The court observed that notes on a check merely provide useful notes for the debtor's record keeping.

Protecting Your Sales With A PMSI And Avoiding The Battle For The Proceeds

A very close call for the vendor. Indeed, one of the judges considering the bank's appeal (a three judge panel decides the issue) authored a dissenting opinion contending that the vendor lost the first battle as the buyer's check was dated the day after delivery, not before. The problem for the vendor in this case--indeed, for any vendors selling to distributors who then sell the merchandise to retailers--is that neither the debtor nor the retailer cared whether the retailer's payment was made "on or before the delivery" of the merchandise. What to do?

The best way to avoid a battle of the proceeds in this situation would have been for the vendor to include a provision in its contract with the debtor, e.g., when the debtor sells its inventory, payment must be made in cash on or before delivery of the inventory. The vendor did not have such a provision and thus was left to the whim of the debtor and the retailer as to whether payment was to be made "on or before the delivery." As the court stated, "Purchase money secured creditors would behoove themselves to require by contract that all payments for the sale of the purchase money inventory be received in cash on or before the delivery."[3]

1. 85 F.3d 131 (4th Cir. 1996).

2. 85 F.3d at 138.

3. 85 F.3d at 137.

UCC SEARCHES IN THE COMPUTER AGE (Continued)

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Lien Searches In The Computer Age

Perfecting a security interest in personal property is a multi-step procedure under Article 9 of the Uniform Commercial Code. When the debtor obtains secured financing, the debtor first executes a security agreement describing the collateral, which gives the creditor a security interest in the collateral. The creditor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State and, perhaps, the County Clerk) which adequately describes the collateral.

Section 9-402 of the Uniform Commercial Code provides that a financing statement must include the names of the debtor and the secured party. But section 9-402 also provides "[a] financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading." The court framed the issue as whether leaving "Tire" out of the debtor's name was seriously misleading to the searcher. If it was found to be seriously misleading, it would render the seller's lien avoidable by the trustee.

As a general rule courts treat mistakes involving a descriptive word as minor and not seriously misleading. The court provided three illustrations where courts have let stand liens through mistakes were made executing financing statements: (1) "Excel Stores, Inc." was filed as "*Excel Department Stores, Inc."*; (2) "Nara Non Food Distributing, Inc." was filed as "Nara Food Distributing, Inc."; and (3) "The Kohn's Supermarket, Inc." was filed as "Kohn's Supermarket *d/b/a Best K Foods, Inc.*"

The court stated:

> "When determining whether an inaccuracy in the naming of the debtor in the financing statement was a 'minor error' which was 'not seriously misleading' a court must ask whether a reasonably diligent searcher would be likely to discover a financing statement indexed under the correct . . . In this regard the inquiry must question the extent of the discrepancy between the debtor's true name and that indicated on the financing statement so as to determine whether the filing gave the minimum information necessary to put any searcher on inquiry."[2]

The trustee's computer search did not uncover any lien filed under the debtor's name. The trustee argued that the financing statement must be filed under the exact name of the debtor or it would be seriously misleading to the searcher conducting a computerized lien search. The court conducted its own search, manually, and concluded that a manual search would have located the indexed name and uncovered the lien.

A Credit Executive's Diligence With Lien Searches

The court discussed the duty of creditors in conducting their UCC searches:

> "This Court wishes neither to encourage nor to dissuade the use of computers. If they are to be used, however, that use may not excuse or compromise the level of care which a creditor must exercise in conducting its search of lien filings. To the extent that a human searcher would inevitably examine all corporate names having certain basic components, a computer searcher should act similarly. It will not suffice to perform a word search for the precise corporate name. Rather, the interested party should expand its investigation to include **all related entries through which a manual searcher might have stumbled**."[3]

The court's decision goes beyond the issue of the propriety of computer versus manual lien searches. Rather, the court appears to burden credit executives to search every reasonable variation of a debtor's name, whether conducting a manual or computerized search. The court seems intent on protecting sloppy secured creditors at the expense of unsecured creditors. The court, however, provides little guidance on how broad a search must be before a missed name may be considered "seriously misleading." Credit executives who search UCC records before selling on open account should conduct very broad searches, whether by computer or manually.

1. 194 B.R. 23 (Bankr. W.D.N.Y. 1996).
2. 194 B.R. at 24.
3. 194 B.R. at 26.

MECHANIC'S LIEN AS A DEFENSE TO A PREFERENCE ACTION? (Continued)

(continued from page 2)

the combined claim of the top three creditors who did attend the meeting.

Working with outside counsel, we determined that Division might have mechanic's and/or materialman's lien rights at the Midwest facility. However, our rights would expire prior to the ABC's shipment of the machine. There was also some question that our scope of supply qualified as an improvement to the Midwest realty (and thus qualified under the Midwest state's lien statutes).

We determined that if we did not receive payment, but ABC found itself in bankruptcy proceedings within 90 days of that payment, then we would likely have to surrender the payment as a preference (we received greater value than similar unsecured creditors).

However, any bankruptcy of ABC would be in ABC's home state, where counsel thought a payment made to satisfy a lien claim would not be viewed as a preference -- **the exchange of a waiver of lien for payment, might be considered a contemporaneous exchange of equal value**.

Despite our request to the contrary, the Midwest company paid ABC the **second to last** progress payment in order to secure the shipment of the equipment. Our rights expired in June, but were then renewed later the month when ABC shipped the equipment to the Midwest location. Need-

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MECHANIC'S LIEN AS A DEFENSE TO A PREFERENCE ACTION? (Continued)

(continued from page 8)

less to say, the Midwest company was less than pleased when we filed the lien.

One Sunday in July, one of the region's largest banks foreclosed upon ABC. As I learned later on the same day as the foreclosure, the bank sold all of the assets of the company to the debtor's former CFO. The next day, the successor re-opened the facility with essentially the same employees, the same work in progress, etc.

The $600,000 loan to capitalize the success was made with no money down, and collateralized by real estate owned by the father of former CEO. The foreclosure was followed within a few days by an **involuntary** Chapter 7 bankruptcy by three creditors located in ABC's home state. Since I had previously been in contact with these creditors, on the day preceding the filing our company was given the courtesy of being advised of the creditors' intentions.

In October, the Midwest company agreed to pay the final $80,000, under Midwest's state law we could insist upon the entire $135,000 that ABC owed us -- because we notified the Midwest company prior to the **second to last** progress payment. At the time of our notification, the Midwest company had more than enough funds let to cover our $135,000. Although somewhat disappointed, we were hoping the future business from the Midwest company, and agreed to accept $80,000 less the $15,000.

The Midwest company and to an extent even ourselves each considered this agreement to be a "win-win" situation. The Midwest company paid no more than what they had expected to pay, and we received, almost half of our money within a shorter time frame (and without the uncertainty) of a bankruptcy.

We received payment and, in exchange, executed a waiver of lien. **This payment subsequently survived a preference review by the Chapter 7 bankruptcy trustee.**

Four years later, our company remains the only creditor paid. The lawsuit against the bank regarding the terms of thee foreclosure and sale is winding down. Once resolved, we hope to be able to see this case closed by mid-1997. Depending upon the settlement with the bank, unsecured creditors may receive 10 cents on the dollar - not the unrealistic 61 cents on the dollar promised by the debtor early in the case.

Our company received $65,000 out of $135,000 (48%), and we stand to share pro-rata with any distribution by the debtor. In the event that the distribution is 10 cents on the dollar, then we would realize 10% on $70,000 ($135,000 less $65,000 received), or $7,000. If so, our total distribution will be $72,000 ($65,000 plus $7,000), or 53% of $135,000.

P.S. Although the case is not being held in a Pennsylvania jurisdiction, I have used this technique in two Pennsylvania bankruptcies with similar results. Each situation also involved pacing a lien on a third party who owed money to the debtor. The first case involved a $70,000 debt in a bankruptcy being heard in the Western District. The second case involved a $16,000 debt in a bankruptcy being heard in the East District. In order to have the liens released, the third parties would pay my company, at the expense of the debtor's estate.

In neither of these three cases did the trustee contact me. It may be that this technique simply goes unnoticed amid the other aspects of the bankruptcy.

1. Doug Fox, CCE, has worked in business credit for twenty years, and is active as a director (formerly Chairman) of the Philadelphia affiliate of The National Association of Credit Management.

RESTITUTION REVISITED (Continued)

(continued from page 5)

The more difficult issue for courts is the lender's acquiescence when a vendor provides merchandise to the debtor. When a vendor provides merchandise or a service that is necessary to preserve the collateral, such as harvesting crops, this is an expense the lender would ordinarily incur as part of its duty to maintain the collateral. In these situations, the lender directly benefits and a vendor's claim for restitution may stick.

However, it becomes less clear for a vendor when its merchandise or service is not essential but merely useful, such as delivery of corn. In this sense the collateral available to the lender for liquidation is merely being made more accessible. In these situations courts are reluctant to disrupt the transaction out of concern that a favorable ruling to a vendor could encourage swarms of potential litigants to challenge what may otherwise be clear rules contained in Article 9.

Protecting Your Sales

In light of the principle that courts will generally not disrupt a lender's foreclosure of a debtor's collateral in absence of the factors like those discussed above, how does a vendor protect itself while supplying a debtor whose lender holds a floating lien? The simplest method to avoid a third party's foreclosure on your collateral is not to sell on credit. Of course, this approach may result in a loss of sales to customers who genuinely may not be credit risks, and who will then look to purchase from your competitors on credit.

An alternative is to investigate the debtor through the appropriate governmental office (usually the Secretary of State or County Recorder's Office) to determine if a lender has already granted a security interest that poses a threat to repayment. In addition, consider taking a purchase money security interest in the merchandise. One could also consider approaching the lender to request a subordination of the value of your merchandise to the lender's lien.

1. 29 Cal. App. 4th 1357, --Cal.Rptr.2d-- [Oct. 1994.]

MARSHALING ASSETS: FORCING A SECURED CREDITOR TO GET PAID FROM THE GUARANTOR (Continued)

(continued from page 3)

a corporate debt:

> "[I]nasmuch as a corporation is an entity distinct from its stockholders or officers, as between a senior creditor of the corporation, who can also look to its stockholders or officers if he has a guaranty, and a junior creditor who has no guaranty and thus can look only to the corporate assets, the necessary condition of a common debtor does not exist, absent a basis for disregarding the corporate entity."[3]

This separate entity is the reason courts generally do not compel a bank to satisfy its claim against the guarantor's assets in lieu of the debtor's assets.

However, courts recognize limited exceptions to the common debtor requirement in the context where a principal guarantees the corporate debt. Where the corporate veil could properly be pierced so as to ignore the apparent separate identities of a shareholder and the corporation, the common debtor requirement may be satisfied. Likewise, when a shareholder's property should be deemed to be a contribution to the capital of a corporation, the common debtor requirement may be met.

The court noted:

> "[W]hen a guarantor who is also a controlling shareholder provides the bank with the primary collateral needed to obtain a working capital loan to either initiate or continue the operation of the debtor corporation, the 'common debtor' requirement is satisfied and the equitable remedy of marshaling is available."[4]

The reasoning supporting the exception is that vendors are induced to extend credit to a company that has been provided financing. Should the company fail, equity merits the bank look first to its guarantee to be paid, to avoid undue burden on the unsecured creditors of the corporate debtor.

The court considered the assets of the principals to be available exclusively to the bank. The court determined that because the principals' mortgages directly secured a corporate note, not the guarantee, a common debtor is found. Likewise, the bank has a claim against the debtor by virtue of the cross-collateralization agreement. However, because the debtor did not benefit from the proceeds of the note (the principals were not required to put money into the debtor company), the bank must first look to the principals as to this claim.

Only One Creditor Has Access To Both Funds

The unsecured creditors of the debtor company do not also hold claims against the principals. However, the bank, by virtue of the personal guarantee has claims against both the debtor company and the principals.

Prejudice To The Secured Creditor

The bank argued against foreclosing first against the principals' real estate, because the real estate might be environmentally contaminated. The court believed that the real estate was not so contaminated that it would greatly diminish the value of the real estate. The court determined that the equities balanced in favor of the bank first foreclosing on the principals' real estate. To the extent there was a shortfall, the bank may look to the debtor company's assets to then satisfy its claim.

Acting On Behalf Of Unsecured Creditors

A bankruptcy court has authority to order the marshaling of funds to obtain an equitable distribution of funds to creditors of the debtor. As a general rule neither the debtor nor an unsecured creditor may assert the marshaling doctrine. However, some bankruptcy courts recognize that a bankruptcy trustee may assert the doctrine on behalf of unsecured creditors under the trustee's status as a hypothetical lien creditor under his or her "strong arm" powers.

Applying Marshaling To Your Case

The ruling in Pietsch may be important for unsecured creditors. According to the Pietsch court, where the bank is a two-fund creditor, the ruling may mean that unsecured creditors of the corporate debtor get paid as opposed to the debtor's principal retaining his or her assets. However, marshaling applies in only certain situations. Unsecured creditors do not have standing to assert marshaling. Nor does a chapter 11 debtor. Rather, it is junior secured creditors and bankruptcy trustees, in certain jurisdictions, that may assert the doctrine.

The party asserting marshaling must act early. If a junior creditor or trustee knows that a senior creditor contemplates selling secured property of the company, but does nothing to prevent the sale, the junior creditor or trustee may not assert marshaling. While marshaling may not be commonly applied, it is a doctrine worth considering by unsecured creditors in negotiating with a bankruptcy trustee or, perhaps, a junior secured creditor, when faced with an insolvent debtor company and a principal guaranteeing the company debt.

1. 200 B.R. 207 (Bankr. E.D. Wis.)
2. 200 B.R. at 209.
3. 200 B.R. at 210.
4. 200 B.R. at 211.

OBTAINING RELIABLE INFORMATION ON A NEW ACCOUNT MAY NOT INCLUDE RELYING ON BANK'S COMMENTS ABOUT DEBTOR'S FINANCES (Continued)

(continued from page 4)

discussed below.

The Loan Officer's Comments

A bank provided a line of credit to finance the debtor. The vendor contemplated selling the debtor on credit. The credit executive of the vendor phoned the bank's loan officer on two occasions and posed questions as to the bank's view of the debtor's finances. The loan officer stated that it felt the bank's line of credit would be sufficient to satisfy the debtor's obligation to the vendor.

The loan officer also stated that the debtor's account was satisfactory, that the loan officer was comfortable with it, and the loan officer viewed the bank's relationship with the debtor as long term. The loan officer did not provide the vendor with any meaningful financial information, such as inventory levels and volume of accounts receivables.

The vendor extended credit to the debtor and the debtor failed to pay. The vendor sued the bank. The vendor also sued the bank for negligent misrepresentation and fraud based on the statements of the loan officer.

The Court's Analysis

The court stated that the loan officer's casual remarks about the debtor's financial condition did not amount to fraud, even if true. The loan officer's statement that the bank "felt" that the line of credit would be adequate was merely a prediction of the customer's future performance. Similarly, the vendor could not have relied justifiably on statements that the customer's account was "satisfactory", that the bank was "comfortable" with it, and the bank "regarded its credit relationship with [the customer] as long term." The court noted:

> "The bank officer did not provide any of the material financial information, such as its bank balance, size of its inventory and volume of accounts receivable, necessary for an informed business decision. [The vendor] could not have justifiably relied on these two telephone conversations with a bank officer in deciding to [the debtor] on credit."[2]

The court dismissed the vendor's lawsuit against the bank.

A Vendor's Due Diligence

Most bank's no longer provide credit references of their customers to avoid the risk of being sued by the debtor's vendor. However, the court is saying that even if the bank is willing to provide a credit reference, such a reference is likely insufficient to hold the bank responsible for a poor credit decision by the debtor's vendor. Of course, it is understandable for a vendor to look for other pockets to offset its loss to the debtor. But the court is saying the vendor is in the best position to protect itself from loss. Vendors must be more thorough before making open account sales to new accounts. Vendors should look to various sources of information described above to assist in their credit decisions. The court, at least in this instance, will not create a safety net for the vendor in the form of the bank where credit sales do not work out.

1. 641 N.Y.S.2d 25 (1996).
2. 641 N.Y.S.2d at 25.

PROMISES, PROMISES?. . . LENDER'S LETTER EXPRESSED INTENT BUT NOT PROMISE TO PAY VENDOR (Continued)

(continued from page 4)

> lender] plans to supply funding for R&E to bring your account current as quickly as possible. In order to establish our pay-off plan for your account, we must verify all account balances . . .
>
> Upon completion of our initial analysis, we will be in contact with you concerning our plans to bring your account to current status. We look forward to a continuing relationship. Your patience and understanding is greatly appreciated. You can look for great things to happen in the future with R&E."

The turnaround lender also requested that the vendor fill out an account verification form.

Several months later the vendor still had not been paid by either the debtor or the turnaround lender. The vendor filed suit against both the debtor and the lender to collect on the open account balance. In the complaint, the vendor alleged the turnaround lender had assumed responsibility to pay the account and had promised to pay off the account. The trial court found that the lender promised to pay off the open account and ruled in favor of the vendor, finding both the debtor and the lender responsible for the obligation. The debtor filed bankruptcy. The lender appealed, contending it had not, in fact, promised to pay off the account.

A Promise to Pay: Principles of Contract

A contract is generally defined as an agreement between two or more persons which creates an obligation to do something. A promise may constitute an agreement. A promise binds the maker for the happening of a future event. No form of words is necessary to constitute a promise binding in law. However, not all promises are real and thus not binding:

> "A supposed promise may be illusory because it is so indefinite that it cannot be enforced, or by reason of provisions contained in the promise which in effect makes its performance optional or entirely discretionary on the part of the promisor; accordingly, a promise to pay an employee a bonus and/or commission to be decided upon after three months is illusory."[2]

The Appellate Court's Ruling

The appellate court reversed the decision of the trial court, finding that the lender in its letter merely expressed an intent to provide funding to the debtor. The letter did not state a promise to pay the vendor's account and thus the turnaround lender had not bound itself to pay off the account. The appellate court noted that the credit manager for the vendor's testimony that the letter was the sole communication between the parties.

A Lesson for Credit Executives

The turnaround lender's letter does appear to be a promise to pay the vendor's account. As such it would bind the lender, as opposed to a general statement of proposed financing of the debtor, that would not bind the lender. The turnaround lender stated that it had entered into an agreement to provide financing with the debtor. The turnaround lender requested that the vendor complete an account verification form based on "plans to supply funding for R&E to bring your account current as quickly as possible. In order to establish our pay-off plan for your account, we must verify all account balances. . ." This certainly appears to go beyond an expression of intent simply to provide financing for the debtor. Even so, this court found otherwise.

To protect itself, is there something the vendor might have done to "firm up" the turnaround lender's apparent promise or agreement to pay its debt? The appellate court found it important that there was no further communication between the turnaround lender and the vendor after the letter; no phone calls and no confirming letters. It appears the appellate court is advising vendors to "pin down" turnaround lenders if they expect them to pay their debts.

On way to pin down a turnaround lender may be to send a letter confirming the turnaround lender has agreed to assume responsibility for the debt. The confirming letter requests the turnaround lender respond immediately if its understanding is otherwise. Such letters *from the vendor* confirms the turnaround lender's promise to pay the particular account--or provides the turnaround lender the opportunity to clarify its position.

If the turnaround lender clarifies its position and disavows that it will not pay a particular debt, the vendor may promptly proceed with its lawsuit against the debtor.

1. 473 S.E.2d 376 (N.C. App. 1996).
2. Sanderman v. Sayres, 50 Wash 2d 539, 314 P2d 428.

LEAVING MORE ON THE TABLE FOR UNSECURED CREDITORS IN BANKRUPTCY: CHANGING THE ABSOLUTE PRIORITY OF SECURED CLAIMS (Continued)

(continued from page 5)

Rights Of Secured Creditors In And Out Of Bankruptcy

Before considering the proposition of a partial-priority rule for secured creditors, a brief background of priorities of claims follows. A secured creditor enjoys two rights not held by unsecured creditors as provided under state law: (1) right of repossession wherein, should a debtor default the lender has the right to repossess the collateral identified in its security agreement; and (2) right of priority, wherein the lender has a superior right to the collateral identified in its security agreement, which is superior to the rights of unsecured creditors.

In bankruptcy, secured creditors are key players, that act individually. Where the secured creditor holds a security interest in the debtor's inventory and accounts receivable and the proceeds from these

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LEAVING MORE ON THE TABLE FOR UNSECURED CREDITORS IN BANKRUPTCY: CHANGING THE ABSOLUTE PRIORITY OF SECURED CLAIMS (Continued)

(continued from page 12)

assets, that secured creditor's role is especially crucial. To use the secured creditor's cash collateral, the debtor may enter into an agreement with the the secured creditor or obtain a court order.

Where the secured creditor consents to the debtor's use of cash, the secured creditor ordinarily extracts concessions from the debtor this is detrimental to unsecured creditors. Where there is no agreement between the debtor and the secured creditor, the debtor must establish that the secured creditor's collateral is adequately protected. This means the secured creditor is entitled to be compensated by the debtor for any diminution in the value of its collateral during the bankruptcy proceeding.

Upon a bankruptcy filing, the automatic stay arises which enjoins creditors from collecting their debts. A secured creditor may request the court to allow it relief from the automatic stay so that it may repossess its collateral. To do this, the secured creditor must establish that its collateral is not adequately protected, or the collateral does not have any equity, or the debtor does not need the collateral to reorganize. A secured creditor is also entitled to post-bankruptcy interest on its claim, to the extent the secured creditor's claim is fully secured. The value of the collateral identified in the security interest equals the amount of the claim.

Rights Of Unsecured Creditors In And Out Of Bankruptcy

Outside of bankruptcy, state law provides that should a debtor default on the terms of a contract, the unsecured creditor may reduce its claim to judgment, and instead enforce the judgment by accepting other property belonging to the debtor. The levying creditor takes the debtor's assets as it finds them. If a debtor has encumbered its assets, the levying unsecured creditor's judgment is junior to a secured creditor.

Once the debtor files bankruptcy, the unsecured creditor is prohibited from taking action to collect on its claim. If the unsecured creditor did not obtain a judgment and enforce it prior to bankruptcy, the unsecured creditor may not proceed on its own.

Unless a particular unsecured creditor's claim is disproportionately large, unsecured creditors act collectively in the form of an official creditors' committee. Such a committee's dealings with the debtor are more manageable than the entire body of unsecured creditors' individual dealings would be. The committee permits them to speak in a unified voice and assures that creditors are represented who would otherwise be unable to effectively participate in the bankruptcy because of economic constraints.

Priority Of Claims In Bankruptcy

The Bankruptcy Code establishes the following priorities for creditors:

(1) Secured claims (to the collateral identified in the creditor's security interest);
(2) Postbankruptcy administrative claims, which includes claims of vendors selling to the debtor on open account, and attorneys and accountants employed by the bankruptcy estate;
(3) Claims arising after the commencement of an involuntary bankruptcy;
(4) Wage and other compensation-related claims, up to $4,000 per individual;
(5) Employee benefit claims;
(6) Claims of farmers and fisherman;
(7) Customer claims, up to $18,000;
(8) Claims for alimony or child support;
(9) Government tax claims;
(10) Claims of the FDIC;
(11) Unsecured, prepetition claims--the typical vendor claims in bankruptcy; and
(12) Equity

The priority scheme is mandatory. A debtor may not elevate the priority, for example, of a vendor's unsecured, prepetition claim. Likewise, a debtor (or other creditors) may not subordinate a creditor's claim without legal justification.

The Problem With Secured Claims In Bankruptcy: The Nonadjusting Unsecured Creditor

The article cites statistics that most secured debt is issued to small and medium-sized companies: 78% of total volume of small-business loans were secured. Accordingly, most companies that file bankruptcy fall within the small to medium-sized range.

The central theme of the article is that secured creditors divert value from unsecured creditors that do not adjust the size of their claims to take into account the secured creditor. The authors discuss the various types of nonadjusting creditors:

> "The size of the claims of any tort creditors will not take into account the existence of a security interest encumbering the borrower's assets. Similarly, the size of government tax an regulatory claims will be fixed by statute without regard to the possibility that the claims may be subordinated by a secured claim in bankruptcy. There will also be nonadjusting creditors whose claims arise out of voluntary dealings with the borrower. Many creditors will have claims that are simply too small to justify the cost of taking the security interest into account when contracting with the borrower, and will thus be 'rationally uninformed' about the borrower's financial structure. Finally, <u>any contractual creditor that extends credit on fixed terms before a decision is made whether to create a particular security interest, and is therefore unable to adjust its claim to take into account the fact that the security interest is created, will be nonadjusting with respect to that security interest."</u>[2] (emphasis added).

It is not uncommon for vendors to have granted substantial lines of credit to a debtor and then learn the debtor has subsequently encumbered all of its assets to a bank. The vendor is a non-adjusting creditor. A non-adjusting vendor's credit analysis to support repayment of its account is no longer relevant in this case because of the superseding secured claim, that of the bank.

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LEAVING MORE ON THE TABLE FOR UNSECURED CREDITORS IN BANKRUPTCY: CHANGING THE ABSOLUTE PRIORITY OF SECURED CLAIMS (Continued)

(continued from page 13)

The authors propose a solution to the problem of the non-adjusting creditor: only partial priority to secured claims in bankruptcy. Partial priority is proposed through a rule or an alternative rule, each of which has the effect of leaving secured creditors at least partially unsecured, with the value of that portion of the secured creditor's collateral which is now unsecured being transferred to nonadjusting, unsecured creditors. The rules are intended to prevent a security interest from being used to transfer bankruptcy value from nonadjusting creditors.

The law review article proposes an interesting concept. The road to legislative change can be a long one, but, special interest groups, such as credit associations, may apply pressure on legislators in Washington, saying a partial-priority rule for secured creditors in bankruptcy is a more equitable method than the system currently used to treat certain types of unsecured creditors.

1. Bebchuck and Fried, 105 Yale Law Journal 857 (1996).

2. 105 Yale Law Journal at 864.