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THE TRADE VENDOR QUARTERLY

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

A "PROPER PURPOSE" FOR COMMENCING AN INVOLUNTARY BANKRUPTCY PETITION: PRESERVING A PREFERENCE ACTION

Scott Blakeley

In evaluating various collection remedies, vendors collectively may find the commencement of an involuntary chapter 7 or chapter 11 bankruptcy petition (the Bankruptcy Code excludes chapters 9, 12 and 13 involuntary proceedings) to be one of the most effective tools they have against a debtor to collect on their delinquent open account in appropriate circumstances, as an involuntary bankruptcy may be viewed as the ultimate prejudgment attachment since it freezes the debtor's assets for the benefit of all creditors. But an involuntary bankruptcy petition may not be filed for an improper purpose.

The historic purpose of involuntary bankruptcy is to provide vendors with a means of assuring equal distribution of the debtor's assets. In addition to assuring an orderly liquidation and equal distribution of assets, an involuntary proceeding may benefit vendors (once an order for relief is entered) as a trustee can use the Bankruptcy Code's avoidance powers to recapture fraudulent conveyances, preferential transfers and unseat improperly perfected liens. Disclosure of financial information is enabled through filing Schedules and Statement of Financial Affairs and Interim Statements and Operating Reports. Lastly, expansive investigative powers permit discovery of a debtor's prepetition transfers of assets. Timing may be an important element when considering whether to file an involuntary petition. The longer a vendor waits, the more difficult it may be to recoup property of the estate.

The United States Congress sought to liberalize the standard for initiating involuntary petitions in 1978 by abolishing the "acts of bankruptcy" standard set forth in the Bankruptcy Act of 1898. Under the Bankruptcy Act, petitioning creditors were required to establish that the debtor had committed an act of bankruptcy, such as: (1) fraudulent transfer; (2) preferential transfer; (3) assignment for benefit of creditors; (4) appointment of state court receiver; or (5) written admission of inability to pay debts. The practical effect of establishing an act of bankruptcy was proving the debtor's insolvency. In most instances, though, a vendor could not gather sufficient information to establish a debtor's insolvency. By the time sufficient information was finally collected, often the debtor's assets had dissipated. With the enactment of the Bankruptcy Reform Act of 1978, Congress sought to accommodate the filing of involuntary bankruptcy petitions at earlier stages to increase the likelihood of reorganization and thereby increasing the likelihood of distribution to vendors.

A balance was needed, however, to discourage frivolous filings against financially healthy debtors. Congress imposed certain filing criteria on petitioners: (1) Petitioners' unsecured claims must aggregate at least $10,000; (2) The debtor is generally not paying its debts that are not the subject of a bona fide dispute as they come due; (3) Petitioner's claim is not contingent as to liability or the subject of a bona fide dispute; (4) Three creditors must join in the petition if the debtor has twelve or more creditors; and (5) The court may order petitioning creditors to post a bond. A further deterrent to frivolous filings is the possibility of costs, attorneys' fees, consequential and punitive damages being awarded against petitioners if it is determined that the involuntary petition was commenced in bad faith or for an improper purpose.

The Circuit Court of Appeals for the Eleventh Circuit in *General Trading Inc. v. Yale Materials*[1] recently considered whether a vendor had commenced an involuntary petition for an improper purpose and whether to uphold an award of punitive damages against the vendor. In *General Trading*, the petitioning creditor discovered that the debtor was liquidating its assets through fraudulent and preferential transfers, and that the debtor had resolved not to pay the petitioning creditor's claim. The Circuit Court ruled that the petitioning creditor had filed the petition for a proper

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Guest Column

TIMING IS EVERYTHING

Chuck Klaus
Credit Managers Association of California[1]

In today's environment of continuing defaults and business failures, creditors should consider the services of the Adjustment Bureau of Credit Managers Association of California ("CMAC") and how it can help repair communications between a debtor and its creditors. Experience has taught us that communication is often the bridge that results in a successful resolution to a debtor's reorganization. Below is an example of a collection problem that many of you face all too often. CMAC's participation ultimately made the difference.

Early in the year, I received a telephone call from a CMAC member who described a familiar collection problem. Eight or nine members of his/her trade group were experiencing collection problems with the same customer. The debtor was past-due well beyond 120 days with everyone. Numerous promises for payment had been broken. The "story" about an infusion of cash from an outside source was no longer credible, even though, the debtor's optimism continued to buy time with its vendors. Simply stated, the debtor's credibility had hit rock bottom. Everyone agreed that it was time to take action, only, no one could agree on the best course of action to take.

Upon getting involved, I immediately set up a telephone conference with the creditors who expressed an interest in meeting with the debtor. During that telephone conference, it was learned that the owner of the company was personally known by many of the creditors. The long-term relationship with some, admittedly colored their judgment in extending additional credit, even though the debtor's cash flow problems were well known. The debtor even had a good reputation of "pulling himself out of trouble" in the past.

Several of the creditors had already initiated collection litigation against the debtor in hopes of inducing payment. Everyone recognized that when a debtor can no longer "rob Peter to pay Paul", the debtor will almost always file bankruptcy as a means of self-preservation. Unfortunately, once the plan to file bankruptcy is put into action, the odds of the debtor surviving are dismal. It is well known that on a national average, less than 5% of all companies that file Chapter 11 result in a successful reorganization, with money being paid to unsecured creditors. In other words, the odds are that 95 out of 100 Chapter 11 filings result in liquidation.

As a former banker, many of the commercial credit accounts that I handled were involved in bankruptcy. Most Chapter 11 reorganizations were eventually converted to Chapter 7 liquidation. Five to seven years seemed to be the average time it takes a Chapter 7 Bankruptcy Trustee to administer the liquidation of a company. In ten years of banking, I honestly do not recall receiving any recovery from a Chapter 7 Trustee. It is, therefore, not surprising that in any bankruptcy proceeding, the fees and expenses of the professionals seem to exhaust the assets of the estate as administrative expenses have priority over general unsecured creditors. As an unsecured creditor, not only does your investment finance the administration of the bankruptcy process, but you could be the target of a preference action.

Preferences can take on the form of a "Double Whammy". Unfortunately, if you were aggressive in your collection efforts early on and successful in collecting on your past-due account (within 90 days of the bankruptcy filing), the payment that you received will most likely be deemed to be a preferential transfer. At some point in time, the odds are that you will be subject of a lawsuit to disgorge those funds back to a bankruptcy Trustee. The law of redistributing those funds pro-rata among the general unsecured creditors is nice to talk about in theory, but in reality, most of the funds collected as preferential transfers are used to pay legal and administrative fees.

At the conclusion of the telephone conference, it was agreed that CMAC's Adjustment Bureau would schedule a meeting with the debtor. Each creditor agreed to participate in person. In addition to providing current financial information, the debtor would be asked to give a brief presentation about the overall financial condition of the company. The claims of individual creditors would not be discussed, but rather the emphasis would be placed on how unsecured claims as a whole, could be repaid through the alternative of an out-of-court reorganization. Everyone agreed to withhold independent collection efforts, pending the outcome of the proposed meeting.

My initial telephone conversation with the debtor was met with skepticism. Most debtors are not aware of the alternatives to bankruptcy. Considerable time was spent in educating the debtor about Credit Managers Association of California and the forum we provide, by which the debtor and its creditors can meet to discuss their differences. Once the lines of communication are reestablished, a workable solution is often found. I gained the confidence of the debtor, who understood that the meeting was intended to be constructive. A meeting date was agreed upon.

At the meeting, the creditors group learned that the debtor had resigned itself to the fact that it did not have the resources to

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FROM THE PUBLISHER:

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Readers' comments and questions are welcome and should be addressed to: Scott Blakeley of Blakeley & Blakeley LLP, Wells Fargo Tower, 2030 Main Street, Suite 540, Irvine, CA 92614. Phone: 949-260-0611 or Fax 949-260-0613 or Home Savings Bank Tower, 660 South Figueroa Street, Suite 1830 Los Angeles, California 90017 Telephone: (213) 385-5815 Facsimile: (213) 385-5817.

Copies of The Trade Vendor Quarterly ***are available by contacting Scott Blakeley at the above address or phone. He can also be reached at his e-mail address as follows:***

sblakeley@bandblaw.com

or the firm's web site at www.bandblaw.com

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

FAILURE TO GIVE EFFECTIVE NOTICE MAKES BUYER OF ASSETS LIABLE TO VENDOR IN BULK SALE

Scott Blakeley

A debtor looking to liquidate its assets may find the bulk sale of assets, as opposed to a piece-meal disposition, maximizes asset values for creditors. The Uniform Commercial Code (UCC) sets forth the procedure for the buyer of a debtor's assets to notice the debtor's creditors of the bulk sale. The purpose of notifying creditors is to allow them to file claims for amounts owing.

The recent opinion of *In re J&A Holdings*[1] shows that parties to a bulk sale that fail to strictly comply with the notice requirements of the Bulk Sales Act, and also attempt to keep notice of the impending sale from the vendor holding the largest unsecured claim, will not be met with understanding. In *J&A Holdings*, the court found that the buyer failed to comply with the notice requirements of the Bulk Sales Act and was therefore liable for a vendor's claim for unpaid goods provided to the debtor.

The Bulk Sales Act

The Bulk Sales Act is designated as Article 6 of the UCC. Each state adopts a variation of the Bulk Sales Act. The Bulk Sales Act generally provides that where a debtor proposes to sell more than half of its inventory and equipment, not in the ordinary course of business, the buyer must give notice to the debtor's creditors. Transfers of a substantial part of equipment will also fall under the Bulk Sales Act if made in connection with a bulk transfer of inventory. Businesses whose activities often fall within the provisions of the Bulk Sales Act are retail merchants who sell product without making substantial changes to it.

The Bulk Sales Act excludes certain transactions: (1) when a business merely changes structure; (2) a general assignment for the benefit of all the creditors; and (3) a transfer to a solvent entity with a known place of business in the state who gives notice that it has become bound to pay the debts of the seller. The last kind of transfer is excluded because it involves little risk to the creditors. The creditors themselves may enforce the buyer's obligation to pay the debtor's debts and thus have possible remedies against two parties - the debtor and the buyer.

The buyer of bulk inventory is required to give notice of the sale to the debtor's creditors. Depending on a state's variation of the Bulk Sales Act adopted, notice must be in two forms: (1) recorded notice of the sale at the county recorder's office where the assets are located; and (2) publish notice of the sale once in a newspaper of general circulation where the assets are located. Depending on the state, the buyer may have to mail notice directly to the debtor's creditors advising of the bulk sale. To have a claim allowed, a vendor must timely file its claim.

The statute attempts to combat fraud by parties to a sale in situations such as: (1) a debtor sells its assets to a friend or family member for less than fair value, pays creditors less than the full amount of their claims, and restarts the business under a new name; and (2) a debtor sells its assets for any price and then absconds with the sale proceeds.

The primary purpose of the Bulk Sales Act is to provide a debtor's creditors with notice so as to have their claims paid, or take protective action before the debtor transfers its assets and makes off with the sale proceeds.

The consequence of noncompliance with the Bulk Sales Act is that the transfer is ineffective against any creditor of the debtor.

Proper Notice of Bulk Sale Given?

In *J&A Holdings*, the debtor sought to sell all of its assets to a newly formed company. The newly formed company was owned by an officer of the debtor. A vendor had been selling on open account to the debtor on nearly a daily basis. The vendor continued to sell the debtor to the day before escrow closed on the sale of assets, as the vendor was unaware of the impending sale. The debtor owed the vendor $72,000 on open account. The debtor failed to inform the vendor of the sale, and the debtor refused to discuss the impending sale with anyone.

Under the terms of the purchase agreement, the buyer agreed to purchase all of the debtor's assets but to exclude payment on the trade debt. The buyer attempted to timely publish notice of the bulk sale. The vendor did not file a claim with escrow. The vendor subscribed to a service that provided printed daily notices of intended bulk transfers which were recorded. This service listed the buyer's notice, but because the issue was delivered by second class mail, the vendor learned of the sale after it closed. The vendor was not able to file a claim timely for payment. The sale price of the assets was less than the total amount of the vendor's claim. The vendor sued the debtor and the buyer for the amount of the open account balance. The court dismissed the vendor's claims against the buyer and the vendor appealed.

Failure to Comply With Notice Provisions

The appellate court found that the buyer failed to comply with the notice requirements under the Bulk Sales Act, by failing to record notice 12 days prior to the sale, as required under the California statute. This tardy delay prevented the vendor from filing its claim in time to be considered for distribution.

"The central purpose of the bulk sales statutes is to afford a merchant's creditors an opportunity to satisfy their claims before the merchant can transfer his or her assets and vanish with the sale proceeds . . . The purpose of this statutory scheme is to protect creditors by giving them notice in time to take action before the transfer takes place. It provides a mechanism for the filing and payment of claims through escrow. It requires that creditors be notified where to file claims and the date of the last day to file claims . . . Otherwise, creditors do not have sufficient time to file a timely claim."[2]

Good Faith Commercially Reasonable Effort Defense Not Available

The Bulk Sales Act provides a defense for buyers who establish that they made a good faith and commercially reasonable

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RESTRUCTURING DELINQUENT DEBT THROUGH GUARANTEES NOT FRAUDULENT TRANSFERS TO VENDOR

Scott Blakeley [1]

How do you restructure a delinquent open credit line, especially one that is a source of significant business to you -- and vital to the debtor's operations -- when a debtor is in financial straits? You want assurance that the delinquent account will be repaid, and future shipments will be timely paid. You want collateral, as much as possible, to secure the delinquent account. The debtor is willing to provide collateral, virtually all unencumbered collateral to ensure continued flow of your product.

In what instances may guarantees or property transfers by a debtor to a vendor to secure past due debt and secure future shipments be deemed fraudulent and subject to recapture by a bankruptcy trustee? The court in *In re El Mundo Corporation*[2] considered whether transfers from a debtor-newspaper publisher to a newsprint supplier, through a series of guaranties, constituted fraudulent transfers.

Debtor Defaults

In *El Mundo*, a vendor supplied newsprint to the debtor, a newspaper publisher, on open account. Prior to the bankruptcy filing, the debtor became delinquent. To ensure continued supply of paper, the vendor and the debtor entered into agreements that allowed the supply of newsprint to keep flowing despite the debtor's inability to pay for it. The vendor was owed $4 million, of which over $2 million was delinquent. The debtor issued a promissory note for the delinquent amount backed by a $1 million bond.

The debtor also began assigning accounts receivable to the vendor to maintain the paper supply it needed to keep the paper running. After further financial problems, the debtor executed two personal mortgages as a guarantee. A few months later, the debtor commenced a chapter 11 case that was later converted to chapter 7. The chapter 7 trustee sought to avoid the payments to the vendor under the theory that the transfers were fraudulent as the debtor did not receive fair value for the transfers. The bankruptcy court found that the transfers were not fraudulent. The trustee appealed.

Elements Of A Fraudulent Transfer

Some debtors with sinister intent may devise intricate schemes to channel assets away from creditors. In other instances, a debtor, without such sinister intent, has to unload his property to raise badly need funds. However, the debtor does not receive reasonably equivalent value for the transfer. The power to avoid transfers or incurrence of debt by a debtor having sinister intent, or when a debtor in financial straits does not receive reasonably equivalent value for the transfer, goes a long way toward protecting creditors from detrimental transactions.

Whether a transfer may be deemed fraudulent requires considering several factors, including the fraudulent intention of the parties, the financial condition of the debtor, the relative value exchanged, and the relationship of the debtor and the recipient of the transfer.

There are two general types of fraudulent transfers: the intentional fraudulent transfer and the constructive fraudulent transfer. The intentional fraudulent transfer is made with the actual intent to hinder, delay or defraud creditors. These derive directly from the Statute of Elizabeth from the Sixteenth Century. Certain "badges of fraud" have been employed by courts for centuries if such transfers are made with the intent to hinder, delay or defraud creditors: the transfer is to an insider; the debtor retained possession or control of the property transferred; the transfer or obligation was concealed; before the transfer, the debtor was sued or threatened with suit; the transfer was of substantially all of the debtor's assets; the consideration received by the debtor was not of fair value; the

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A CREDITORS' COMMITTEE'S RIGHT TO INVESTIGATE AND SUE A CHAPTER 11 DEBTOR'S PRINCIPALS

Scott E. Blakeley

Upon a Chapter 11 bankruptcy filing, the debtor company's principals retain their positions and are permitted to continue to operate the business and attempt to restructure the debtor's financial obligations. However, the principals do not enjoy a completely unrestricted environment. In a Chapter 11, a creditors' committee is appointed (usually) which has various duties and powers and has the right to investigate -- and sue -- the debtor's principals in certain jurisdictions. In *In re Catwil Corporation*, the bankruptcy court spelled out a creditors' committee's right to sue the debtor's principals after the debtor had failed to do so.

Appointment of Creditors' Committee

Upon the filing of a bankruptcy petition, payments to unsecured creditors are suspended. Vendors seeking to recover on their invoices must assert claims against the debtor. Because a typical Chapter 11 bankruptcy often involves hundreds, sometimes thousands, of unpaid vendors, many of whom hold claims of relatively modest amounts, a creditors' committee is an efficient device. The creditors' committee deals with the debtor in a more manageable fashion than would be possible if each individual vendor represented themselves. Additionally, the creditors' committee ensures representation of smaller vendors who would otherwise be unable to effectively participate in a bankruptcy case. The bankruptcy estate comprises the assets and liabilities of the Chapter 11 debtor.

Powers of Creditors' Committees

In Chapter 11, the Bankruptcy Code vests a creditors' committee with expansive duties and powers. These duties and powers include: (1) consulting wit the debtor on the administration of the case; (2) inves-

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FAILURE TO GIVE EFFECTIVE NOTICE MAKES BUYER OF ASSETS LIABLE TO VENDOR IN BULK SALE (Continued)

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effort to comply with the statute. The buyer contended that even if it did not strictly comply with the notice requirements of the Bulk Sales Act, it made a good faith and commercially reasonable effort to comply with the requirements, and thus was not liable for the vendor's claim. Commercial reasonableness has been defined as fair treatment afforded to parties. The court found no evidence of a good faith and commercially reasonable effort to comply with the Bulk Sales Act.

The court noted that the buyer knew that the vendor was a major creditor of the debtor because the president, as an employee of the debtor, placed orders to the vendor. The court also noted that the buyer knew that notice of the sale had not been properly recorded, and knew the identity of the major creditor of the debtor, yet sat silently by neither recording new notice nor giving actual notice to the known creditor. The president of the buyer, as an employee of the debtor, continued to order goods from the vendor and said nothing about the sale. The amount due the vendor exceeded the entire purchase price of the debtor's assets.

Thoughts For Vendors

The *J&A Holdings* ruling demonstrates the protections that the Bulk Sales Act may provide to a debtor's trade creditors, especially where a debtor and buyer may engage in inequitable behavior. Consider the following situation. Your debtor has just closed its doors. The former officers advise you -- after the fact -- that the debtor has sold its assets in bulk and you have missed the date to file a claim. Your best move may be to have the bulk sale transaction, including the notice, examined. You may find the buyer (perhaps the debtor's former principals) failed to comply with the notice requirements and may therefore be your deep pocket for payment on your claim.

1. 54 Cal. App. 4th 996, 63 Cal. Rptr. 2d 253 (1997)
2. 54 Cal. App. 4th 1003.

RESTRUCTURING DELINQUENT DEBT THROUGH GUARANTEES NOT FRAUDULENT TRANSFERS TO VENDOR (Continued)

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debtor was insolvent or became insolvent.

The constructively fraudulent transfer is made without actual intent by the debtor to hinder delay or defraud, but the transfer is deemed unfair to creditors where the debtor transfers assets for less than reasonably equivalent value while it was in financial distress (such as insolvency at the time of transfer, had unreasonably small capital as a result of the transfer, or incurred debts beyond its ability to repay by virtue of the transfer). The policy supporting the constructive fraudulent transfer is that a debtor may transfer assets for any value while it is financially healthy and paying its creditors. Where the debtor is in financial distress and creditors will not be paid in full, the transfer may be attacked as constructively fraudulent as the transfer did not yield fair value for the asset.

A trustee in bankruptcy has two different mechanisms for avoiding fraudulent transfers. Section 548 of the Bankruptcy Code permits a trustee to avoid the types of fraudulent transfers specified therein. Section 544 of the Bankruptcy Code gives a trustee whatever avoiding powers an existing unsecured creditor might have under applicable nonbankruptcy law, e.g., the Uniform Fraudulent Conveyance Act. Under Section 548, a trustee may attack a transfer made within a year of the bankruptcy filing. Under Section 544, there is generally a longer reach back period.

Fair Value Given

The *El Mundo* court evaluated certain factors in determining whether the debtor's granting guarantees to the vendor constituted fraudulent transfers: the haste with the transfer; the debtor's insolvency; the relationship with the vendor and the claims against the debtor. The court observed that the overall relationship between the debtor and the vendor demonstrated that their principal motivation was to continue their business relationship:

> "First, there was no haste whatsoever in the issuance of the guarantees to [the vendor]. Before the agreement and each amendment, [the vendor] investigated and received assurances of the viability of [the debtor], even visiting the newspaper facilities on one occasion. Second, [the debtor] was in difficult financial straits at the time, but its was not insolvent. Third, the relationship between [the vendor] and [the debtor] is particularly revealing. [The vendor] was the supplier of an essential element of [the debtor's] product: The paper on which it was printed. Their relationship was strictly commercial. The guarantees [the debtor] made to [the vendor] were absolutely necessary to continue the paper's publication during those difficult times and forestalled the paper's demise considerably."[3]

The court found that the guarantees provided to the vendor fostered the business relationship between the debtor and vendor. There was no evidence that the business relationship could be stretched to a fraudulent transaction.

A Reminder to Vendors

Two types of transactions may be attacked as fraudulent under debtor-creditor law: actual or intentional and constructive transactions. For the vendor looking to collateralize a delinquent account and continue to supply the debtor, as in the *El Mundo* case, the transaction will likely not be unwound as an intentional or actual fraudulent transfer as the parties lack the actual intent.

However, where the debtor provides guarantees for a vendor's delinquent open account, the guarantees may later be attacked if a court determines the vendor did not give reasonably equivalent value for the property at a time when the debtor was in financial distress. Looking at the transaction from the view of the financially distressed debtor, what did the corporation receive in return for providing the guarantees for the delinquent account? A vendor may be protected from such attack where it continues to supply the debtor after receiving the guarantees.

1. 208 B.R. 781 (D.Puerto Rico 1997).
2. 208 B.R. 782-83.

A "PROPER PURPOSE" FOR COMMENCING AN INVOLUNTARY BANKRUPTCY PETITION: PRESERVING A PREFERENCE ACTION (Continued)

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purpose and not in bad faith, which was to protect itself and prevent other creditors' from obtaining a disproportionate share of the debtor's assets. By commencing the involuntary petition, the vendor sought to preserve the 90 day reach back period to recover preferential transfers.

Eligibility to File

An eligibility requirement to file an involuntary petition is that the petitioner be a creditor holding an unsecured claim aggregating $10,000. If a debtor has greater than 12 creditors, then three petitioning creditors' claims must aggregate $10,000. Secured creditors may waive their security to be eligible, or else have an unsecured portion of their claim that aggregates $10,000.

Claims Subject To A Bona Fide Dispute

A petitioning creditor must hold a claim that is not subject to a bona fide dispute. The Bankruptcy Code does not define "bona fide dispute," but the established standard disqualifies a creditor whenever there is a legitimate basis for the debtor not paying the debt. The reasoning behind excluding claims subject to a bona fide dispute is to prevent creditors from using involuntary bankruptcy as a club to coerce the debtor into paying debts for which the debtor, in good faith, believes it has legitimate defenses. To disqualify a petitioning creditor on the grounds that the claim is subject to a bona fide dispute, a dispute must exist as to the validity of the entire claim and not merely a portion of the claim.

The Debtor Generally Not Paying Its Non-Disputed Debts As They Come Due

The petitioning creditor or creditors must assert that the debtor is generally not paying its debts as they come due. The Bankruptcy Code does not define the "generally not paying" test. The standard is not to be applied mechanically; it is not a matter of simple mathematics of paid debts to unpaid liabilities. Rather, courts employ factors, the most common of which are: (1) timeliness of payments of past-due obligations; (2) amount of debts long overdue; (3) length of time during which the debtor has been unable to meet large debts; (4) reduction in the debtor's assets; (5) the amount of the debtor's debt compared to the amount of the debtor's yearly income; (6) the debtor's liquidity; and (7) whether insiders deferred payment on account of sums payable to them.

To determine whether a debtor is generally not paying its debts involves consideration of the totality of the circumstances, balancing the interests of the debtor and creditors. The fact that a debtor is not paying the petitioning creditors may not be sufficient to prove an involuntary petition in itself. Where claims of petitioning creditors represent a substantial percentage of the debtor's outstanding indebtedness, courts have found that the creditors satisfied the standard for generally not paying debts. "Generally not paying" has been described by one court to mean that the debtor is regularly missing a significant number of payments which are significant in amount in relation to the size of the debtor's operations.

The alternative standard for commencing an involuntary bankruptcy petition is the transfer of substantially all assets by a debtor to a third party for an out-of-court liquidation. The creditors must file the involuntary petition within 120 days of the transfer.

Commencing The Involuntary Petition

In *General Trading*, the vendor and the debtor had entered into a marketing agreement wherein the debtor acted as a dealer for the vendor's products. A dispute ensued between the parties, resulting in the vendor terminating the marketing agreement and the debtor refusing to pay on the open account. The debtor sued the vendor for termination of the agreement.

The vendor, along with two other creditors, filed a Chapter 7 involuntary bankruptcy petition against the debtor. The vendor was the major creditor of the debtor. The bankruptcy court dismissed the petition, ruling that the vendor's claim was subject to a bona fide dispute based on pending litigation.

As the vendor's claim was subject to dispute, that vendor's claim was excluded when determining whether the debtor was generally paying its debts. With this significant claim excluded from the debtor's liabilities, the petitioning creditors failed to prove that the debtor was generally not paying its debts as they became due. A magistrate court ruled that the vendor had filed the involuntary petition for an improper purpose and in bad faith. The court awarded the debtor punitive damages and attorneys fees amounting to $587,000.

Vendor Shows That The Debtor Transferred Assets

The vendor appealed. The appellate court determined that the vendor was motivated by proper purposes in bringing the involuntary petition, as the vendor's primary concern was to protect itself and prevent other creditors from obtaining a disproportionate share of the debtor's assets. The court observed that the debtor was paying other creditors, and the vendor had reason to believe that the debtor was liquidating all of its assets. The debtor had transferred a substantial amount of its inventory to an insider. The vendor also had evidence that the debtor had transferred large amounts of money to insiders and other creditors. Evidence showed that a number of creditors had received preferences that could only be legally recovered by a bankruptcy proceeding. By commencing the involuntary petition, the vendor sought to preserve the 90 day reach back period during which preferential transfers may be recovered.

The Vendor's Proper Purpose For Commencing Petition

In *General Trading*, the appellate court found that the vendor had filed the involuntary petition for a proper purpose, which was to protect itself against other creditors' obtaining a disproportionate share of the debtor's assets:

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A "PROPER PURPOSE" FOR COMMENCING AN INVOLUNTARY BANKRUPTCY PETITION: PRESERVING A PREFERENCE ACTION (Continued)

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> "[the vendor's] decision to file the petition was partly motivated by a well-founded belief that it needed to fall within the 90 day preference period to enable it to reach back and recover money transferred by [the debtor] to non-insiders."[2]

The appellate court observed that the vendor was legally justified in filing the petition, and had a reasonable basis in law to think its petition would not be dismissed. The bankruptcy court had dismissed the involuntary petition because it determined that the debtor was generally meeting its debts as they came due. In calculating the debtor's liabilities, the bankruptcy court excluded the substantial claims of the vendor because they were subject to a "bona fide dispute". If, however, the bankruptcy court had considered the vendor's claims, the debtor clearly could not pay its debt when due. Here, the court found that the vendor's claims may not have been subject to a bona fide dispute.

As the vendor had sufficient reasons to file the involuntary petition (recover preferential payments that otherwise would not be recoverable), and as the vendor had a good faith basis in believing its petition would not be dismissed as a result of its claims being subject to a bona fide dispute, the court ruled in favor of the vendor.

Bad Faith Filings And The "Improper Purpose Test"

A court may dismiss an involuntary petition upon its determination that a petitioner's motives for filing were in bad faith. Neither the Bankruptcy Code nor its legislative history defines bad faith. Rather, courts determine bad faith on a case-by-case basis. Several tests have emerged in determining bad faith. One test measures, by an objective standard, what a reasonable creditor in the position of the petitioning creditor would have done. Another test applies a subjective standard, investigating the petitioning creditor's motives.

Under these tests, courts ask whether the petitioner was motivated by an improper purpose, such as malice, ill will or desire to harass the debtor. In applying these tests, courts have found the following situations to constitute bad faith: a petitioner's motivation for filing was to destroy the debtor; a petitioner was motivated by ill will to shut down the debtor's business; an involuntary petition was filed to force the debtor into labor negotiations; a petition was filed to gain settlement leverage; the bankruptcy proceeding was used as a substitute for customary collection proceedings; and a petitioner filed in an attempt to take over the debtor corporation.

Upon a finding of bad faith, the court may award fees, costs, compensatory damages and punitive damages to the debtor.

Courts have found a petition filed under the following situations not to constitute an improper purpose or in bad faith: to preserve an avoidance action (preference and fraudulent conveyance claims); to resolve intercreditor disputes through a plan of reorganization; to prevent loss of assets, obtain financial information and institute orderly workout of claims without preference to creditors; and to prevent collusive or "friendly" foreclosures or transactions. An example of the last was when a principal offered relief on his guarantee in exchange for the secured creditor foreclosing on assets.

Commencing The Petition For A Proper Purpose: The Vendor's Due Diligence

Recovering preferential transfers is the core of the Bankruptcy Code's protections of ensuring equal treatment of vendors. The *General Trading* opinion reminds vendors that they must determine that they are filing for a proper purpose before they commence the involuntary petition, and that they have a good faith basis in believing the petition will be allowed to stand. *General Trading* suggests that vendors motivated to file an involuntary petition to preserve the reach back period to recover preferential transfers is not improper or in bad faith. This is true, provided the petitioning creditor has conducted due diligence as to the validity of its claim and the debtor's insolvency.

1. 119 F.3d 1485 (11th Cir. 1997).
2. 119 F.3d 1503.

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successfully reorganize the business. In order to maximize the liquidation value of its assets, the debtor had located a prospective buyer. Since the buyer did not want to assume the debtor's liabilities, it requested that the acquisition be consummated in a bankruptcy proceeding.

The debtor's Balance Sheet revealed that the company had assets with a book value of approximately $80,000, against liabilities of $350,000. Priority claims (taxes) were estimated to be approximately $30,000. On a straight liquidation basis, the creditors could potentially recover seven cents on the dollar. If the debtor liquidated the assets in Chapter 7 bankruptcy, everyone agreed that this would be a "no asset" case for unsecured creditors. In other words, the fees and expenses of the bankruptcy Trustee and other professionals would be expected to dissipate the net sale proceeds.

An alternative to Chapter 7 bankruptcy, a General Assignment for the benefit of creditors was proposed. This is a liquidation under state law. Experience has shown that General Assignments are more efficient and less costly than Chapter 7. Lower cost translates into greater recovery for creditors. The ease in which the assets can be sold in General Assignment was also appealing. Not only is the process less expensive and quicker (no court hearings and pleading, etc.), creditors are encouraged to monitor the process by forming a Creditors' Committee.

The debtor found the meeting to be very constructive and informed the prospective buyer of the General Assignment alternative. Upon further discussion with the debtor and its counsel, the debtor agreed to liquidate the assets through a General Assignment, naming CMAC as Assignee.

Prior to the debtor executing the General Assignment, the prospective buyer took a final inventory to establish its bid price. The prospective buyer had already established the formula for which it would pay for each item. The only remaining detail was to count each item of inventory. Since the Assignee has a fiduciary responsibility to sell the assets in a reasonable commercial manner in order to maximize value, the fair market liquidation value could only be established by inviting competitive bidding. Therefore, as part of CMAC's willingness to administer the General Assignment, the buyer had to agree to have its offer tested by advertising the sale and inviting other interested parties to submit offers.

The physical inventory count revealed that the debtor's initial inventory report was inaccurate. According to the physical inventory count, the debtor had slightly over $50,000 in inventory at cost. In reality, it became evident that the debtor had been living off its inventory while trying to decide what course of action to take.

The general Assignment was subsequently executed transferring all of the debtor's rights, title and interest in the assets to CMAC as Assignee. CMAC advertised the sale in order to solicit bids from all interested buyers. As anticipated, the bid of $45,000 from the prospective buyer was by far the highest bid received. CMAC, as Assignee subsequently transferred its title to the assets to the buyer. Subsequent to the sale, creditors' claims attach to the proceeds of the sale. Due to the inventory adjustment, the potential recovery for unsecured creditors shrank to approximately 2 cents on the dollar.

Unfortunately, the outcome for creditors in this case was less than anticipated, primarily due to the previously unknown shrinkage in inventory. Most creditors will tell you that collecting two cents on the dollar is hardly worth discussing at the next corporate board meeting. However, this case demonstrates that as small as the projected recovery is, absent the General Assignment process, recovery for unsecured creditors would have been nil. In retrospect, this case scenario reinforces the message that "timing is everything". Would creditors have gotten a better recovery if group action had been initiated earlier? We will never know for sure, but earlier action could have prevented the debtor from living off its inventory, at the expense of its unsecured creditors, while it pondered what to do.

In dealing with troubled companies, the forbearance of aggressive collection measures by creditors is often taken advantage of by the debtor. Instead of identifying and correcting the problems, management is slow to implement change. In the interim, the debtor is most likely living off the inventory you provided. In banking, when the bank officer believes that his relationship with the debtor has become too close to exercise good business judgment, the bank officer is encouraged to bring in a third party who can bring objectivity to the decision making process. Likewise, when creditors observe serious cash flow problems with their customers, utilizing the services of CMAC's Adjustment Bureau can help facilitate a resolution between the debtor and its creditors. Otherwise, time and assets are often wasted.

Just as this case illustrates, had the debtor known about CMAC, I was told that it would have utilized our service much earlier. Instead, weeks, possibly months went by as the debtor searched for a resolution. Instead of throwing your hands in the air and adding to your reserves for bad debt, call CMAC's Adjustment Bureau at (800) 541-2622. We could be the difference between your next loss and a recovery.

1. Chuck Klaus is the Estate Manager for Credit Managers Association of California.

A CREDITORS' COMMITTEE'S RIGHT TO INVESTIGATE AND SUE A CHAPTER 11 DEBTOR'S PRINCIPALS (Continued)

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tigating the acts and conduct of the debtor, as well as its assets, liabilities, overall financial condition, as well as the operation of the debtor's business and the feasibility of continuation of the business; (3) formulating a plan of reorganization; and (4) requesting the appointment of a trustee or examiner.

The creditors' committee acts as liaison between its constituency, the unsecured creditors of the bankruptcy estate, and the debtor. This tries to ensure efficient and fair settlement of the debtor's financial difficulties. The creditors' committee also plays the role of watchdog, and has broad powers to investigate the debtor. If there is evidence of mismanagement within the debtor company, there may be a claim against the debtor's current and/or former officers, directors, and major shareholders (the principals or insiders). An investigation of this kind might focus on preferential transfers, fraudulent conveyances, or breach of fiduciary duty.

A Chapter 11 filing may ensue for numerous reasons that do not call the management's integrity into question. Notwithstanding the impetus for the filing, claims against the principals may be one of the most valuable assets of a bankruptcy estate. For example, under bankruptcy preference law, transfers made by an insolvent debtor one year (for insiders) prior to the bankruptcy filing date may be recaptured, subject to certain defenses. Under constructive fraudulent conveyance law, transfers made by the debtor where it did not receive reasonably equivalent value in the transaction may be recaptured. Under a theory of intentional fraudulent conveyance, prepetition transfers made by the debtor (within one year prior to the bankruptcy filing) with the intent to hinder, delay, or defraud creditors may be avoided.

A creditors' committee is a "party in interest" entitled to be heard on all issues. However, the Bankruptcy Code provides that the debtor-in-possession alone has the power to bring an action against its principals on behalf of the bankruptcy estate (unless a trustee has been appointed, when it then becomes the trustee's exclusive right) in order to recapture preferential transfers and fraudulent transfers or sue for damages for mismanagement or breach of fiduciary duty.

Not surprisingly, there is an inherent conflict of interest between the debtor and its principals that makes it unlikely the debtor will initiate actions to recapture transfers or sue for damages against its principals. After all the principals are the very parties who control the debtor's determination of whether to pursue such actions. Additionally, a debtor will not usually pursue claims against its former principals as those former principals can influence the selection of their successors.

Creditors Must Be Vigilant

The debtor-in-possession has only two years from the date of the bankruptcy filing to commence actions in order to avoid preference and fraudulent conveyance actions. Likewise, claims against the debtor's directors and officers insurance policy for mismanagement by principals must be filed within a short time period. The creditors' committee must be extremely vigilant in these situations.

The creditors' committee has a duty to act when the debtor fails to take appropriate action for the benefit of the bankruptcy estate. If the creditors' committee believes that the debtor has failed to fulfill its duty to pursue claims, the committee is obligated to bring this to the attention of the court. However, bringing the debtor's failure to act to the attention of the court does not give the creditors' committee power to file actions against the debtor's principals.

A court may recognize the inherent conflict in a situation where the debtor pursues claims against its principals and creditors are the presumptive owners of the debtor in bankruptcy. Under appropriate circumstances, a court will permit the creditors' committee to bring an action against the principals in appropriate circumstances in lieu of the debtor pursuing such actions. However, the creditors' committee may not bring an action against the principals when the debtor brings such an action itself.

In *Catwil Corporation*, the court faced the issue of whether a creditors' committee must first obtain court approval prior to bringing an action against the debtor's principals. The debtor in *Catwil* filed a Chapter 11. The creditors' committee conducted an investigation and advised the debtor of potential preferential and fraudulent conveyance claims against its principals.

The debtor, not surprisingly, disputed these assertions and chose not to file the requested actions.

Creditors' Committee Takes Action

One day before the expiration of the statute of limitations to pursue the claims, the creditors' committee, on behalf of and in the name of the debtor, filed actions to avoid preferential and fraudulent transfers against the principals and former principals. The creditors' committee did not obtain prior court approval to bring the actions. The principals then sought dismissal of the actions, contending that the creditor's committee should have first obtained permission from the court.

The court recognized the rule embraced by a majority of courts that a creditors' committee must obtain court approval prior to commencing an action against the debtor's principals. The court's reasoning for this pre-approval is that it "reduces the likelihood of the unavoidable confusion that would result if creditors were allowed to file suits at their own discretion." Pre-approval, the court noted, also gives the debtor the opportunity to explain its reasons for declining to prosecute the action sought by the creditors' committee. However, the court recognized an exception to this pre-approval requirement in certain circumstances.

The court found several reasons not to dismiss the action brought by the creditors' committee.

First, the court noted that all of the defendants were principals of the debtor. Because of the close relationship of the debtor with the principals, an inherent con-

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A CREDITORS' COMMITTEE'S RIGHT TO INVESTIGATE AND SUE A CHAPTER 11 DEBTOR'S PRINCIPALS (Continued)

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flict of interest existed, making it unlikely that the debtor would pursue any actions against these parties. Second, the debtor was aware of the creditors' committee's intention to file the complaints. Third, the creditors' committee was required to act immediately because the statute of limitations was set to expire. The creditors' committee's action was not dismissed.

The *Catwil* ruling serves a useful reminder to creditors' committees of the duty to investigate and pursue claims on behalf of their constituency, the unsecured creditors. Upon appointment, the creditors' committee should establish an agenda for the case, including a reasonably prompt investigation into whether any potential claims exist, including preference and fraudulent transfer claims and claims for mismanagement and breach of fiduciary duty against the debtor's principals or former principals.

Timely Action Required

Where colorable claims exist, the creditors' committee should notify the debtor of these potential claims and determine what steps the debtor intends to take to recover the assets. Where the debtor refuses to act, the creditors' committee should request that the court permit the creditors' committee to pursue these claims. Because of the relatively short timetable to pursue these actions, the creditors' committee must move promptly with its investigation in order that this potentially fruitful avenue of recourse not be lost.