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THE TRADE VENDOR QUARTERLY

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

IS SARBANES OXLEY MAKING IT EASIER FOR THE CREDIT PROFESSIONAL TO PUT THE PUBLIC CUSTOMER ON CREDIT HOLD?

CONVERTING A CREDIT SALE TO CASH IN THE SARBANES OXLEY ERA

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Effective August 2004, Section 409 of the Sarbanes Oxley Act (**SOX**) expands the number and type of financial events companies must disclose in 8-K forms. Until this change, most companies reported very few significant corporate events, often waiting to disclose the financial information in quarterly or annual reports.

This new rule may aid suppliers selling to these companies by increasing the number of material events that must be disclosed, versus what is currently required. In the past, there was a long lag time between the event and the company disclosing the event to the public, including suppliers selling the company on credit.

The new rule adds developments that must be reported on Form 8-K and shortens the filing deadline to four days. Previously depending upon the nature of the disclosure, companies had between five business days and 15 calendar days after a triggering event to file 8-K's.

Given the more prompt and full disclosure that a public customer must make regarding its financial condition, the disclosure may result in you taking action earlier and perhaps holding orders more timely, thereby reducing the risk of loss. A Section 409 disclosure may trigger a process in which you determine whether or not open account terms are still appropriate, and if so, under what terms and conditions future sales can be made safely.

More Timely Financial Disclosures Under SOX

Section 409 requires public companies to make additional disclosures to the financial markets:

1. The removal or resignation of any corporate director and the entering into or withdrawing from an important agreement;
2. Agreements that are made or terminated outside the company's ordinary course of business;
3. Entry into a material agreement;
4. Termination of a material agreement;
5. Creation of a material, direct fi-

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WHEN IS A SALE A CREDIT SALE OR A CONTEMPORANEOUS EXCHANGE FOR NEW VALUE?

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If a vendor ships goods with terms requiring payment within 12-14 days after shipment, does the vendor retain its contemporaneous-exchange defense in a preference action? A recent decision in the Payless Cashways bankruptcy case considers just how far a vendor can take the contemporaneous-exchange defense.

Confor Wood Products Marketing was a long-time vendor of lumber to the debtor, Payless Cashways, a large retailer of home improvement products. The debtor filed bankruptcy and the trustee sought to recover four transfers to the vendor totaling $820,564.36. The bankruptcy court found in favor of the vendor on the vendor's contemporaneous exchange defense, and the trustee appealed the decision to the bankruptcy appellate panel (BAP).

All of the contracts between the parties were destination contracts, Free on Board (F.O.B.) the debtor's facilities. The payment terms were 12-14 days if shipped by railroad, 3-5 days if shipped by truck. At first impression, it would appear that transactions between the debtor and vendor are credit sales and the vendor would lose its defense that the transactions were contemporaneous exchanges for value.

To prevail on a contemporaneous exchange defense, the vendor has to prove by

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NO MISTAKES PLEASE! WHEN YOUR CUSTOMER FILES BANKRUPTCY TAKE ACTION

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Economists are restating their forecasts and predicting that the economy may continue through difficult financial times, which means the credit professional may be juggling more delinquent accounts and, ultimately, bankruptcies. News of a customer's bankruptcy can be devastating to a vendor selling on credit. However, there may be a number of cost-effective steps a vendor may take to maximize recovery on the credit sale upon learning of the customers bankruptcy filing. Importantly, should the vendor fail to take action, or mistakes are made, the value of the claim may be lost.

This article discusses common mistakes a credit professional could make when a customer files bankruptcy. The topics include (1) filing your proof of claim; (2) getting paid on your reclamation claim; (3) having your executory contract assumed; (4) asserting your offset rights; and (5) qualifying as a critical vendor.

I. Filing Your Proof of Claim

For a credit executive attempting to collect on a delinquent unsecured account, a debtor's bankruptcy filing requires the credit executive to cease collection efforts. Payments on prepetition claims are suspended with the bankruptcy filing, and creditors file a proof of claim for the unpaid value of their goods and services. The purpose of the proof of claim is to give notice to the bankruptcy court, the debtor, the trustee (if one is appointed) and the creditors of claims against the estate. The Bankruptcy Code and Rules spells out specific requirements for a creditor to participate in a distribution of a debtor's assets. Failure to strictly comply with the filing requirements for a proof of cla
im can be disastrous for the credit executive, as a late-filed claim effectively eliminates any distribution.

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

FROM THE PUBLISHER:

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A. Chapter 11 Bankruptcy

Chapter 11 of the Bankruptcy Code provides for the reorganization of a debtor's assets and liabilities, and existing management continues to operate the business. A Chapter 11 debtor must file Bankruptcy Schedules and Statement of Financial Affairs within 15 days of the bankruptcy filing, unless the bankruptcy court extends the time period. The bankruptcy court serves creditors with notice of the bankruptcy filing and a form proof of claim.

1. Who Must File

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

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Guest Column

EQUITABLE LIENS

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A. Introduction

Many court cases state that a subcontractor or supplier has an "Equitable Lien" or "Equitable Interest" in funds held by an owner of a construction project. Like the constructive trusts, these are equitable concepts. In other words, the result will be based on a court's sense of fairness in a particular case, rather than a specific rule of law.

Accordingly, equitable liens are a somewhat muddled and malleable concept. Courts seem to sometimes intermingle the concepts of express trusts, constructive trusts, equitable liens and equitable interests.[1] It can be difficult to nail down the characteristics of equitable liens or interests. For example, does the creditor-beneficiary always have title to the fund, like a trust relationship? Sometimes, the concept appears more like a true "lien," where the debtor trustee has title to the fund, but the creditor-beneficiary has a security interest. The distinction does not seem to make much difference from a practical point of view.[2]

Creditor-beneficiaries would probably prefer to have mechanic's lien rights, payment bond rights, or a trust relationship, partly because the "rules of the road" are more clear in these legal concepts. There seems to be some reluctance on the part of judges and lawyers to recognize the concept of an equitable lien, especially in the bankruptcy forum. An equitable lien claimant seems to fight against the general bankruptcy concept that all general unsecured creditors should share equally in a debtor's assets. The court case law seems to be quite consistent, however, in recognizing the existence of equitable liens. It is also true that creditors with consensual liens have a very preferred position in bankruptcy. There is no apparent reason why an equitable lien claimant should be treated differently.

The concepts seems to appear most frequently in federal cases, concerning federal construction projects in the highest federal courts in the land. Many are Miller Act bond projects, although there is no case stating that this is a requirement for an equitable lien. There are some equitable lien cases arising from state public projects and even private

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PLEADING THE PREFERENCE CLAIM: IS IT GETTING EASIER FOR THE BANKRUPTCY TRUSTEE?

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Credit professionals are finding ever more frequently that the bankruptcy trustee (in Chapter 7) or litigation trustee (often in Chapter 11) view preference claims as a significant asset of the bankruptcy estate. The credit professional is finding that no matter the bankruptcy chapter a customer files, they are a preference target if they received payment within 90 days of the bankruptcy filing. Indeed, USA Today stated: "It is a phenomenon that is sweeping the nation. As bankruptcy filings continue to increase, debtors and trustees are becoming much more aggressive in demanding that creditors return payments received prior to the bankruptcy filing."

In response to the ever growing preference problem, the credit professional, and their counsel, are looking for new angles to defeat the preference claims. Beyond raising the traditional 547 "(c)" defenses (contemporaneous exchange, ordinary course of business and new value), the vendor is challenging the very basis of the preference complaint by seeking dismissal of the suit at the pleading stage contending that the trustee has failed to plead sufficient facts to support the preference suit.

In light of a vendor attacking the preference action at the pleading stage, what is the minimum pleading requirement the trustee must meet in setting forth a preference claim, especially given the uncertain books and records of the debtor? Must a trustee plead the nature and amount of each debt, identify each transfer, including date, name of debtor and the amount of the transfer to sustain a preference action? Or, rather, may a trustee merely make a short and plain statement of the preference claim, and a showing that the trustee is entitled to relief.

In *In re Webvan Group Inc. (Webvan Group Inc. v. Cor Karaffa)* Adv. 03-54365 (CGC)(Delaware 2004), the court found that the Federal Rules of Bankruptcy Procedure does not impose a heightened pleading requirement on a preference claim, and expressly rejected the heightened pleading standard enunciated in recent cases. The case is discussed below.

What Is A Preference

The Bankruptcy Code vests the debtor (or trustee if one is appointed) with far-reaching powers to avoid transfers of assets and monetary transactions prior to a bankruptcy filing. The power to avoid preferential transfers is one of the most powerful weapons a trustee has. The Bankruptcy Code defines a preference expansively to include nearly every transfer by an insolvent debtor 90 days prior to bankruptcy.

The purpose of the preference provision is two-fold. First, unsecured creditors (or undersecured creditors, e.g. those creditors whose collateral is valued at less than their debt) are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

Attacking The Preference At The Pleading Stage

In *Webvan*, the preference defendant sought dismissal of the preference on the grounds that the trustee failed to state a claim. The defendant claimed that the trustee had merely recited the preference statute and had not provided factual information regarding:

(1) the date of the transfers;
(2) the number of transfers;
(3) what property was transferred;
(4) the means of conveyance;
(5) the amount of each individual transfer; and
(6) the alleged antecedent debt on acount of which the transfers were made.

In the alternative, the defendant sought an order requiring the trustee to provide a more definite statement of its preference claim pursuant to Federal Rule of Civil Procedure 12, as made applicable by Bankruptcy Rule 7012.

The trustee objected to the motion to dismiss on the grounds that all facts pertinent to the preference claim had been stated as required by FRCP 12, and that leave to file an amended preference complaint should be granted. (Continued on page 12)

RECLAMATION DEMAND AGAINST CUSTOMER THAT LATER FILES BANKRUPTCY SHOULD BE IN WRITING -- OR RISK PREFERENCE ACTION

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News of a major customer's insolvency can be devastating to a vendor selling on open account. However, the right of reclamation may afford a vendor a cost-effective method of recovery for goods recently shipped if the customer has not filed bankruptcy, or, if the customer files bankruptcy, a priority claim for the reclaimed goods.

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor was defrauded.

One element for a vendor to prevail on its reclamation demand under the Bankruptcy Code is written demand for the return of the goods within ten, or in certain cases twenty, days after the goods were delivered to the debtor, and the goods are identifiable at the time of demand. However, a vendor's failure to strictly comply with the provisions of the Bankruptcy Code reclamation requirements, not merely state law reclamation requirements, may open the door for a preference lawsuit. A bankruptcy court in *In re Zeta Consumer Products Corporation, 291 B.R. 336 (Bankr. D. N.J. 2003),* recently ruled that a vendor reclaiming goods based on an oral reclamation demand resulted in a bankruptcy preference, even though the debtor filed bankruptcy after the vendor had reclaimed the goods (the reclamation was within the preference period).

Reclamation: State Law Right And The Interplay With The Bankruptcy Code

Reclamation is the right of a vendor, the seller, to recover possession of goods delivered to an insolvent buyer, upon demand made within ten days after receipt of the goods, which is provided under Article (Continued on page 13)

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nancial obligation or a material obligation under an off-balance sheet arrangement;

6. Events triggering a material, direct financial obligation or a material obligation under on off-balance sheet arrangement;
7. Material impairments;
8. Notice of de-listing from stock exchange or failure to satisfy listing standards and transfer of listings; and
9. If the company concludes, or the auditors inform the company, that previously issued financial statements, or a related audit report or completed interim review, should not be relied upon.

The SEC estimates these new disclosure requirements will cost American corporations at least $44 million a year to comply. Given that the disclosure requirements will impact suppliers selling to these companies on credit, how do you best protect your interest in the face of a Section 409 disclosure? While a disclosure may indicate future financial difficulty, you may find that a breach of the credit sale may not yet have occurred.

At this stage you are looking to reduce the risk of loss. If you treat the credit sale as repudiated because of the customer's apparent financial difficulty, you may find that you have acted prematurely and be liable to the customer for damages. In light of the more timely and complete financial disclosure caused by Section 409, what should you do to reduce your credit risk however not find yourself the target of claims by the customer that you breached the agreement? What protections does Article 2 of the Uniform Commercial Code offer you as a creditor?

Demands For Assurance Of Payment In Light Of SOX Disclosures

Right To Adequate Assurance Of Performance

Given SOX Section 409's disclosure requirements, what are your rights to place an account on credit hold? Where a supplier has sold goods to the customer on credit and has grounds that the customer may not pay (termed "grounds for insecurity" under Article 2 of the UCC), you may demand written assurance that the customer will perform. Section 2-609 of the UCC provides:

a. A credit sale requires the buyer/customer, and the seller/supplier, to perform. Should grounds for insecurity arise with a buyer's performance, you may demand, in writing, assurance of performance. Until you receive such assurance, you may suspend performance.

b. The customer's failure to provide assurance within a reasonable time, not exceeding 30 days, repudiates the contract and you have no further obligation.

The two questions for you with this remedy are whether the grounds for insecurity are reasonable, and whether the customer's assurance of performance is adequate.

A sample form for an Adequate Assurance Demand Letter follows this paper.

Where Credit Documents Provide For Supplier's Unilateral Right To Terminate Credit Terms

Credit professionals may attempt to short cut the UCC adequate assurance requirement by including in their credit documents the unilateral right to modify or terminate the extension of unsecured credit. The following language may be considered in your company's credit application or in a vendor agreement:

"ADEQUATE ASSURANCE OF PERFORMANCE":

If the buyer fails to fulfill [mitigated by any Force Majeure clause] the terms of payment of any invoice or if the financial responsibility of the buyer shall become impaired or unsatisfactory to the Seller, or if necessitated by any acts of any governmental authority, including financial disclosures mandated by Section 409 of Sarbanes Oxley Act, the Seller reserves the right to change terms of payment and/or deter or discontinue further shipments without prejudice to any other lawful remedy, until past due payments are made and satisfactory assurances of Buyer's credit standing are received by the Seller or until such acts of requirements of such governmental authority shall have been complied with.

The Seller also reserves the right in the case of any of the foregoing events to cancel the contract, in which event the Buyer shall compensate the Seller for any commitments, obligations, expenditures, expenses, and costs including attorney fees, the Seller may have incurred in connection with the contract.

Each shipment by the Seller shall be considered a separate transaction and if payment is not received therefore within the periods specified herein, the Seller at its option may bring a separate suit to recover the contract price of each such shipment. If any of the following events occur, Seller shall have the right to demand assurance from Buyer that payment in full will be made:

1. Buyer is delinquent in making payment hereunder for a period of 45 days after payment was due.
2. Buyer fails to meet his obligations with one or more other suppliers as the obligations occur.
3. A Writ of Attachment or Judgment is entered in any court of competent jurisdiction.

On written demand for assurance by Seller, Buyer shall, within five (5) days after receipt thereof, furnish, in amount sufficient to secure the full payment of the balance of any monies due hereunder on account of the purchase price, either a penalty bond issued by a competent financially solvent surety company, or financial security, bank irrevocable letter of credit, or other liquid collateral to be held in escrow by an attorney at law as designated by Seller, to secure the payment of the purchase price aforesaid."

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Turning A Credit Sale Into A Cash Sale Upon Insolvency

Where a supplier has agreed to sell goods to a customer on unsecured credit, the supplier may refuse to deliver and demand cash upon discovering that the customer is insolvent, as provided under Article 2 of the UCC. The UCC defines insolvent as either balance sheet insolvent (liabilities exceeds assets) or fails to meet debts when they become due.

If Your Company is a Public Company

In the event that your company is itself a public company, and the customer represents a significant portion of your company's accounts receivable portfolio, then your company may be obligated to disclose the possibility of default by a major customer; and/or increase its bad debt reserves to reflect the possibility of the customer's default.

A Note Regarding Written Contracts

In certain industries it is common practice for the creditor and customer to have a written contract for the sale. For example, on large public construction projects, it is common for the owner and general contractor (i.e., seller/creditor) to agree that the general contractor cannot stop its performance for any reason.

Also, Moreover, these contract provisions in virtually all cases these contract provisions "flow down" to other creditors such as to subcontractors, lower tier subcontractors and suppliers/vendors.

Although this may at first glance appear to be horrific from a creditor's perspective, the specific circumstances of the project may suggest such draconian remedies. For example, the repair or replacement of a bridge located on which is an integral part of an interstate highway can cause significant public inconvenience and extreme consequential costs. Typically in all public construction projects, all buyers and sellers agree not to stop work under any circumstance for any reason; and to provide performance and payment surety bonds in order to guaranty their obligations and thus to protect one another in the event of the insolvency of the other. Unfortunately, these wide spread legal provisions have resulted in the bankruptcy of many well known and established contractors (e.g., Guy F Atkinson Company, Morrison Knudson Corporation, Washington Group, J A Jones, etc.). Due to awards based upon the lowest bids, profit margins are often too thin in the industry to compensate a contractor at any tier in the event of unforeseen circumstances. On-line reverse auction bidding in construction projects is rapidly becoming out of favor and legislation is pending to make it unlawful. Sureties, incidentally, usually receive "super priority status" for post-petition bonding in the event of the contractor's bankruptcy.

Consequently, in the event of disclosure under SOX Section 409, the creditor already has the protection of a previously established performance and/or payment bond; and thus, adequate assurance has already been given (Note: typically, there are also large liquidated damage penalties in the event of delays.)

Reducing Credit Risk As A Result Of SOX

For the credit professional, determining if a customer has repudiated the credit sale can be complicated, especially based exclusively on a Section 409 disclosure. However, complying with the adequate assurance requirements contained in Article 2, you may reduce the risk of loss for your company and reduce the risk that you wrongfully terminated the contract.

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Executive Summary

- ◊ Form 8K is a current report filed for any month in which significant events occur for a company subject to SEC rules.
- ◊ The Sarbanes-Oxley Act (SOA) is comprised of a number of sections, each of which requires action by the reporting (issuing) company. Most of the attention thus far has focused on Section 404-Management Assessment of internal controls.
- ◊ Since its arrival perhaps the most significant action has been the requirement for CFOs and CEOs to personally certify and attest to the accuracy of their companies' financial results. Most enterprises were able to comply with that SEC regulation through manual processes and without much tinkering to underlying systems and processes.
- ◊ Section 409 calls for real-time reporting of material events that could affect a company's financial performance. The time-sensitive aspect of this regulation will likely put significant pressure on existing data infrastructures.
- ◊ A Section 409 disclosure may trigger a process in which the credit manager determines whether or not open account terms are still appropriate, and if so, under what terms and conditions future sales can be made safely.

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claim will be subordinate to the unsecured creditor class, which means the claim, as a practicable matter, will be disallowed. A devious debtor will schedule all of its unsecured claims as disputed, contingent or unliquidated in hopes that creditors will not file proofs of claims.

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

2. When a Claim Must be Filed

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

3. Where a Claim Must be Filed

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

B. Chapter 7 and 13 Bankruptcy

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

1. Who Must File

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

2. When a Claim Must be Filed

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

3. Where a Claim Must be Filed

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

C. Proof of Claim Form

1. The Contents and Purpose of Formal Proof of Claim

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

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

2. Informal Proof of Claim

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

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

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

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

D. Priority Claim

The Bankruptcy Code provides that a vendor may be entitled to a priority claim in certain situations. A priority claim is entitled to payment prior to prepeititon claims, and is entitled to payment in cash on the effective date of a plan of reorganization. Priority claims may arise where a vendor's reclamation claim is treated as an administrative claim, instead of receiving the goods in exchange; and where a vendor has sold goods to the debtor on credit postpetition. With a priority claim, the vendor must be certain to check the appropriate box on the

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proof of claim form to ensure the claim is treated to priority.

E. Selling a Claim

With larger Chapter 11 filings, a vendor may be approached to sell their claim. For the vendor, this may mean instant liquidity on the claim, although it usually means selling at a meaningful discount. The question for the vendor is whether to accept the discounted payment immediately, as opposed to holding onto the claim for the upside of a successful Chapter 11 and a meaningful distribution on the claim. A vendor should be mindful as to who bears the risk of loss if the claim is objected to and disallowed, at least in part, the purchaser or the vendor. A number of companies specialize in trading in vendor claims, and almost all major Chapter 11's attract these buyers. With a major Chapter 11 filing, the credit professional should investigate the sale alternative.

F. Reminders

The proof of claim, and the documents supporting the obligation owed, is generally the evidence for a vendor to be paid in a bankruptcy. A vendor must be vigilant with a debtor's bar date so as to timely file a proof of claim. With a debtor's bankruptcy filing, the vendor should pull the documentation from the credit file that supports the delinquent account, such as credit application, invoices and POD's, and be prepared to prove up the claim in the event of a dispute over the claim with the debtor or other party.

II. Getting Paid on Your Reclamation Claim

News of a customer's Chapter 11 filing can be disastrous. However, reclamation may be a cost effective remedy for the vendor. Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor was defrauded. Under the common law and the old Uniform Sales Act, the seller could only exercise its reclamation rights if it proved the buyer obtained delivery by misrepresenting its solvency. However, the Uniform Commercial Code (UCC) has expanded this remedy where the buyer does not misrepresent solvency.

A. Elements of a Reclamation Claim

Courts have settled upon the following elements to establish a valid reclamation claim under the Bankruptcy Code:

(1) the seller sold goods on credit to the debtor in the ordinary course of business of both;

(2) the seller delivered the goods to the debtor at a time when the debtor was insolvent;

(3) the seller made a written demand for the return of the goods within ten, or in certain cases twenty, days after the goods were delivered to the debtor; and

(4) the debtor had possession of the goods at the time of the reclamation demand or the goods were not in the hands of a buyer in the ordinary course or a good faith purchaser at the time of demand.

B. Steps for a Successful Reclamation

1. Reclamation Letter

A vendor initiates reclamation by delivering a reclamation letter within ten days, or in certain cases twenty days, after the goods were delivered. The reclamation letter should include a detailed description of the merchandise in question, a statement of the delivery date to the debtor, and a demand for the immediate return of the goods. The reclamation letter should also demand an accounting. An accounting is crucial, because the right to reclaim may be defeated by the debtor's resale of the goods to a buyer in the ordinary course of business.

If the accounting is not delivered or not accurate, the vendor should be prepared to immediately demand a right to inspect both the inventory on hand the books and records pertaining to sales of said goods for the period between the date of delivery of the goods and the date of the reclamation letter. The letter should be delivered to the debtor by facsimile and certified mail.

2. Initiating Proceedings

If the buyer files bankruptcy prior to the preparation of the reclamation letter (or at any time thereafter) the vendor should promptly contact debtor's counsel in order to stipulate with the debtor either to the immediate return of the goods or for the debtor to sell the goods, provided the vendor is granted an administrative claim or a lien under the Bankruptcy Code. Courts are divided as to whether a reclaiming vendor may simply rely on a proper and timely notice, or must initiate an adversary proceeding, to enforce its rights. The risk the vendor faces if it fails to seek court enforcement of its reclamation right is that it cannot meet its burden of proving that the goods subject to the reclamation demand were in the possession of the debtor at the time such demand was made.

If there are no bankruptcy proceedings, the seller must initiate legal action in state court pursuant to the UCC. The seller should bring a complaint for replevin and a writ of attachment against the proceeds of any sale of goods protected by the reclamation demand.

III. Assuming Your Executory Contract

For the vendor that enters into a supply contract with a customer, as opposed to selling invoice by invoice, the vendor may have special rights in the event the customer files Chapter 11. If the supply contract is deemed an "executory" contract, which is generally defined as substantial performance remaining on both sides of the contract, the vendor may consider having the contract assumed. Assumption of the executory contract means that the debtor must cure the prepetition delinquent account.

However, the vendor must be careful that the debtor's motion to assume the contract shows the accurate owing the vendor to be cured. A craft debtor may assign zero as the amount to be cured. If the vendor does not object, the debtor may argue that the vendor has waved its right to payment in full on the prepetition claim.

Another benefit for the vendor that has its executory contract assumed is that the assumption order may be used as a defense to a preference claims. Courts have found that where a vendor's contract is assumed, such assumption may be an absolute de-

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NO MISTAKES PLEASE! WHEN YOUR CUSTOMER FILES BANKRUPTCY TAKE ACTION

(Continued from page 7)

fense to the preference. Thus, the credit professional should also analyze its preference risk when considering whether to request that the debtor assume the contract.

IV. Asserting Your Offset Rights

A vendor may have a mutual relationship with a customer, both selling and buying goods from a customer. Where a customer files bankruptcy in that type of trade relationship, the vendor should seek to setoff their mutual debts, i.e., where they each owe the other money.

A. Impact of Bankruptcy

The filing of bankruptcy by changes the economics of an open-account relationship involving setoff. Bankruptcy results in a distribution to a vendor which is almost always less than payment in full. If a vendor holds a $1,000 unsecured claim against a debtor, the vendor can expect to receive a pro-rata distribution on account of its claim. Vendors holding claims in bankruptcy are often referred to as holding "bankruptcy dollars," i.e., dollars worth less than 100¢.

In contrast to a chapter 7 trustee's statutory duty to make pro-rata distributions to creditors, a trustee in a chapter 7 bankruptcy case also has a duty to recover the assets of a debtor's estate-in 100¢ dollars. In other words, the trustee's recovery from vendors are in "real" dollars–dollars not discounted. This duty includes the obligation to collect on all open accounts, note receivables, and accounts receivable owing to the debtor. If cost effective, a trustee in bankruptcy will engage in the usual collection actions–hiring a collection agency or filing a lawsuit for open-account claims.

B. Economic Effects of Setting Off

Thus, in the hypothetical example listed above, if we assume (a) that the distribution to the creditors of Supply Company in a chapter 7 liquidation is, say, 6%, and (b) that Wholesaler is permitted to setoff the debts that Wholesaler and Supply Corporation owe each other, Wholesaler's economic position in relation to Supply Company, the Debtor, at the end of the bankruptcy case is as follows:

Wholesaler is owed	$250,000
Setoff–amounts owing to Supply Company	100,000
Net Claim of Wholesaler	$150,000
% distribution in bankruptcy	6 %
Dollar distribution to Wholesaler–at the end of the bankruptcy case	$ 9,000

Assume that (a) Wholesaler is not permitted to setoff the debts that Wholesaler and Supply Corporation owe each other, and (b) the trustee recovers the $100,000 for purchases made by Wholesaler by filing a lawsuit and recovering on the judgment the Trustee obtains. The net economic position is much worse for Wholesaler at the end of the bankruptcy case–in fact, Wholesaler is far worse off than when the bankruptcy case started.

Wholesaler is owed	$250,000
Distribution in bankruptcy	6%
Dollar distribution to Wholesaler	$ 15,000
Less–monies paid by Wholesaler to Trustee:	100,000
Net Loss to Wholesaler:	<$ 85,000>

Consequently, if Wholesaler preserves the right to setoff, Wholesaler is $94,000 better off at the end of the case ($85,000 loss avoided plus $9,000 distribution). Certain legal tests peculiar to bankruptcy law must be satisfied, however, to ensure the right of setoff is preserved. Thus, where large offsetting obligations are involved in a bankruptcy, there is a large economic incentive to hire counsel to ensure that the right to setoff or recoup debts is preserved and permitted.

Setoff generally is designed to facilitate the adjustment of "mutual" obligations. In other words the claim of the creditor and the debt of the debtor must be "mutual." The three technical requirements are that (1) the parties must be the same legal entities, (2) the parties must each own their claim in their own right severally, and (3) the parties must hold their debts in the same capacity.

C. Only Pre-Petition Claims May be Setoff

In bankruptcy, generally, to be permitted to setoff, both obligations have to be "pre-petition." i.e., the creditor holds a "claim" against the debtor that arose before the commencement of the bankruptcy case; and the creditor owes a "debt" to the debtor that arose before the commencement of the case. Setoff is not available to net pre-petition debts against post-petition debts.

V. Qualifying as a Critical Vendor

The credit professional well knows that a customer's Chapter 11 means long delays before receiving any payment on the prepetition account, which payment is usually but a fraction of the claim.

On occasion a vendor may be a key supplier to a customer which files Chapter 11. Given this key supplier relationship, the vendor often holds a sizeable unsecured claim upon the Chapter 11 filing. The vendor, selling invoice by invoice (as opposed to long term supply contract), may elect not to continue to sell the debtor postpetition. However, the vendor's product or service may be viewed by the debtor as essential to its continued operations.

In this situation the debtor may request that the court authorize it to immediately pay the vendor's prepetition claim, in exchange for the vendor selling to the debtor post-bankruptcy on credit. Under the critical vendor doctrine, a vendor may find that the product or service it provides a Chapter 11 debtor is essential to continued operations. The uniqueness of the product or service may give the vendor leverage in negotiating post-bankruptcy sales.

Notwithstanding the Seventh Circuit Court of Appeals recent ruling in the Kmart decision that affirmed the District Court's reversal of the bankruptcy court's authorization to pay critical vendors, the critical vendor doctrine may still be granted by courts outside of the Seventh Circuit.

A. Making the Critical Vendor List

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment. The debtor places the "critical" vendors on a list. Those vendors that do not make the list will receive payment through a confirmed plan of reorganization or Chapter 7 liquidation, often years after the filing. The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment

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NO MISTAKES PLEASE! WHEN YOUR CUSTOMER FILES BANKRUPTCY TAKE ACTION

(*Continued from page 8*)

on the prepetition claim. The motion also binds the vendor to continue to sell with the debtor on terms equal to or better than prepetition terms.

The dollar amounts sought may be high. WorldCom Inc., for example, was authorized to pay vendors up to $70 million. The average relief granted to a mid-sized debtor has ranged from $8 million to $25 million. The responsibility to define the vendors typically has been placed in the hands of the debtors. When a company files for bankruptcy, it reviews a list of its vendors and decides which ones are critical in order to stay in business.

Another strategy for a debtor is not identifying their critical vendors in court pleadings, which are public documents, to avoid alienating those vendors who don't make the list. It seems the leverage of the critical vendor request may be shifting from the vendor to the debtor. The vendor may hold out continued sales to the debtor thereby threatening the debtor's ongoing operations, perhaps only to find a replacement vendor who qualifies as a critical vendor.

B. Capping Trade Claims

The critical vendor doctrine has evolved from the debtor requesting a particular vendor be paid immediately as a critical vendor, to the debtor requesting a class of vendors qualify as critical vendors, to the debtor requesting the bankruptcy court establish a critical vendor "trade claims cap". For example, in the United Airlines Chapter 11, the carrier requested that the bankruptcy court pay trade claims totaling $35 million as critical. United Airlines did not identify the vendors it would deem critical. Rather, United Airlines requested the court authorize payment of a class of vendors it deemed critical which represented about 14% of vendors unsecured claims. United Airlines did not propose to pay in full each vendor deemed critical, but only the minimum for the vendor to continue selling on credit.

The courts application of the critical vendor doctrine continues to evolve. Debtors more frequently request courts' approval of the critical vendor program. Where the doctrine is approved, courts reason, both the debtors and creditors stand to gain something. The critical vendor benefits by receiving early payment on its prepetition claim. The debtor and its vendors benefit by receiving needed product on credit, which may lead to a successful reorganization. A vendor being deemed an essential vendor can have a dramatic impact on the account. The credit professional is not forced to wait what may turn out years for uncertain payment from a reorganizing debtor—so get on the list!

WHEN IS A SALE A CREDIT SALE OR A CONTEMPORANEOUS EXCHANGE FOR NEW VALUE?

(*Continued from page 1*)

a preponderance of evidence that (1) both the debtor and the vendor intended the delivery of the goods to the debtor and the payment of money to the vendor to be a contemporaneous, (2) the exchange was in fact substantially contemporaneous, and (3) the exchange was for new value.

The BAP found that the first element was satisfied because both parties intended the transactions to be contemporaneous, notwithstanding testimony by the debtor that it intended the transactions to be credit sales.

The BAP found the vendor wanted to minimize its credit exposure while providing the goods to the debtor. It did so by requiring the debtor to pay for all lumber by wire transfer by the due date. The parties negotiated an agreement that would assure that the vendor received payment prior to or contemporaneously with delivery of the lumber.

It was undisputed that the vendor shipped the goods to the debtor by destination contract. A destination contract is one in which the seller bears the expense and risk of shipment. All the invoices provided that the goods were being shipped F.O.B. When the term is F.O.B., the seller must at his own expense and risk the transport of the goods to that place and there tender delivery of them in the manner provided. Unlike a shipment contract where a vendor's obligation to a debtor ends at delivery to the carrier, a destination contract requires a vendor to bear the risk of loss, incur the obligation of delivery, and transfer the title at a point designated by the debtor. The BAP found that because the invoices created a destination contract, the parties intended that the right to payment arose upon delivery not upon shipment. Accordingly, the payments were due on or about the time the goods were delivered to the debtor.

As for the second element, a transaction can be substantially contemporaneous even if some separation exists between the time new value is provided and when the payment is received. The bankruptcy court found that there was not a single instance involving any of 25 transactions in which the debtor received goods prior to the time it wired a transfer payment. Based on this examination, the BAP found that the transactions were substantially contemporaneous.

The third element, new value, is defined as money or money's worth in goods, services, or new credit. The BAP considered the issue of when the vendor transferred value to the debtor. Was it when the goods were shipped or when they were delivered? Because the bankruptcy court found that the invoices created a destination contract, rather than the more normal shipment contract, it follows that the new value was given upon delivery not upon shipment. Accordingly, the BAP found that the date of delivery, rather than shipment, is the proper measurement of new value.

In the end the BAP's decision upholds the policy of the defense of contemporaneous exchange for new value, which is to encourage creditors to continue to deal with financially-distressed debtors, as long as their transactions involve true exchanges of equally-valued consideration. The vendor knew it had a problem customer in the debtor and the debtor needed the vendor's goods to continue to do business. The agreement the parties reached resulted in the debtor paying the vendor prior to or substantially contemporaneous with receipt of the goods. The parties performed as agreed and the estate was not diminished as a result of the transfers.

EQUITABLE LIENS

(*Continued from page 2*)

construction projects. Sometimes the provisions in the general contract regarding the payment to subcontractors and suppliers seem important. Other cases discuss a general right in subcontractors and suppliers to receive a contract balance, no matter what the project or the contract terms.

B. General Equitable Right

The US Supreme Court has "recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available monies ahead of others."[3]

Even on private projects, courts have recognized the owner's "well established right to have the laborers and material men paid out of the unpaid progress payments or unpaid balance does not arise from any legal obligations to those who provide it with labor and materials." This "does not arise from any legal obligation to such suppliers but simply from its equitable obligation to those who provided with labor and materials."[4]

It is not new law that unpaid subcontractors hold an equitable interest in a contract balance owed by a building owner to a general contractor. [5]

C. Federal Construction Projects

Most of the case law recognizing equitable liens are from federal courts, even the cases involving private projects. This is probably for historic reasons, arising out of a series of United States Supreme Court cases.[6] It is most clear in federal construction projects that subs and suppliers have an equitable lien in contract balances held by the United States government. This may be because the government has "sovereign immunity" and this results in unfairness. Subcontractors and suppliers are not permitted to file mechanic's liens on government projects.[7] Subs and suppliers are not allowed to sue the government for unjust enrichment or for receiving labor and materials for which the government has not paid.[8] Subs and suppliers cannot even sue the government if it fails to require Miller Act payment bonds.[9]

Sovereign immunity puts subs in a particularly vulnerable position on federal projects.[10] Although no cases say so directly, the concepts of an equitable lien may have been developed by the federal courts to partially provide relief for this problem.

Subs and suppliers have an equitable right to funds held by the government, but have no legal ability to enforce that equitable lien.[11] The Government can, however, waive sovereign immunity and agree to make payment to a subcontractor. The equitable lien gives the government the right to do this.[12] This can be very helpful to a subcontractor, if the government is willing to cooperate. This is most likely to occur if a general contractor has abandoned a project, gone out of business, or gone into bankruptcy.

The equitable lien concept can be very helpful to a subcontractor, when the general contractor files a bankruptcy. The debtor in possession or the bankruptcy trustee will normally seek funds from the government. The general contractor had "privity of contract" with the government. The general contractor is allowed to sue the government to enforce its contract rights. Once the debtor in possession or bankruptcy trustee does this, however, subcontractors and suppliers have an opportunity to assert their equitable lien in the funds held by the government, the trustee or the bankruptcy court.[13]

A subcontractor on a public project should also consider putting a general contractor into involuntary bankruptcy. If successful, the debtor in possession or trustee would have an obligation to collect contract balances from the government. These funds would then be collected in a forum under the watchful eyes of the unpaid subcontractors, and the bankruptcy court.[14]

A subcontractor may be able to enforce equitable lien rights once the government has paid the contract balance to anyone. There is no doubt the subcontractor has equitable lien rights. Once the funds are held by someone other than the government, the subcontractor also has the right to sue to enforce those rights.

Once the funds leave the owner's hand on a public or private project, however, a claimant will have tracing issues. Does the equitable lien continue to exist in the hands of a third party such as a secured lender? Can a secured lender or other third party become an "involuntary trustee" as with trust relationships?[15] There is not much court case law on this subject, but it does seem that a claimant would have the right to traced funds, at least against a third party with notice of the equitable rights.[16]

There are court cases in which an equitable lien claimant-subcontractor established priority over the debtor's secured lender or surety. It seems fairly clear that the equitable lien claimant wins this priority battle.[17]

It seems fairly clear that claimants to a contract balance have priority in the following order:

1. The owner's right of set-off for the costs of completing the project, costs of payment to subcontractors, or other breach of contract claims against the general contractor.
2. The rights of unpaid subcontractors under an equitable lien theory.
3. Payment bond sureties who paid subcontractors pursuant to a payment bond.
4. Assignees of the general contractor, including creditors with perfected security interests, including banks.[18]

It would seem that a subcontractor equitable lien claimant could enforce its rights to a fund in the hands of a surety or bank. This could happen, for example, if an owner was making direct payment to a surety under an assignment agreement or if a bank seized funds from a general contractor's bank account. The same principles with respect to involuntary trustees, discussed above, should apply. In other words, an equitable lien claimant should be able to enforce its rights, but may also need to prove the stakeholder had notice of the equitable rights. The claimant may also have the same tracing issues, discussed above, to identify funds and show that the money in the hands of the stakeholder is the same money received from the construction project owner.[19]

D. Payment Bond Issues

Understandably, equitable lien cases often arise where the government fails to require a payment bond, a claimant has failed to preserve its rights under the bond, or the surety had no liability because it has already paid out the maximum amount of the bond. While many cases discuss some version of these facts, no case has held that

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EQUITABLE LIENS

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any of these facts are essential to an equitable lien claim. In other words, subcontractors have equitable lien claims whether or not the Miller Act applies at all to the project[20] or whether the government has failed to require a miller act bond.[21] A claimant will still have equitable lien rights in a contract balance held by the government, even if the claimant has simply failed to preserve its Miller Act bond rights[22] or the surety is not required to pay the subcontractor because the surety had already paid the full amount of the bond.[23]

E. State Public Projects

Equitable lien rights have been found in state public projects as well. The reasoning in these cases are sometimes equally applicable to private and public projects.[24]

F. Private Projects

Equitable lien rights have also been found in private projects. Most of the language in the federal court opinions would be equally applicable to any private construction project, including the general equitable obligation of the owner to pay the provider of labor and materials discussed above, or the equitable liens based on general contract language discussed below.

Many of these private project equitable lien cases indicate that the equitable lien must be based on the state law involved.[25] It may not be a coincidence, however, that most of these cases are in federal court, in which a federal judge is required to review state law to find the equitable lien right. One case indicates that state law applies, but that "US Supreme Court and other federal cases define the existence of an equitable lien right."[26]

Like many equitable issues, these questions become somewhat muddled. Courts have found state law equitable lien rights based on state mechanic's lien laws or based on state statutes for criminal liability for failure to pay subcontractors.[27] The legal theories in these cases are often a muddled mixture of equitable lien and constructive trusts.

It is also not clear whether there is an equitable lien in many states. Accordingly, the better theory for courts and claimants in many state law or private project cases may be a contractual theory discussed below.

G. General Contract Provisions

Many of the federal project cases, state public project and private construction project cases discuss general contract provisions in finding an equitable lien.[28] Most general contracts state that the general contractor is in breach of contract and/or the owner has no obligation to pay until the general contractor has paid subs in full and the general contractor provides an affidavit to this affect.

Federal regulations require all fixed price construction contracts to provide the following:

> Contractor certification. Along with each request for progress payments, the Contractor shall furnish the following certifications, or payment shall not be made: I hereby certify, to the best of my knowledge and belief, that-…(2) Payments to subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by this certification, in accordance with subcontract agreements and the requirements of Chapter 39 of Title 31, United States Code.[29]

Any property owner, including a public owner, has the right to create contractual obligations with any general contractor to pay all subcontractors on a project. If a general contractor fails to pay the subs, it has no right to further payment.

> [T]he contractor's failure to pay for labor and materials is just as much a failure to perform and carry out the terms of the contract as an abandonment of the work. In short, [the owner] is not contractually obligated to pay the fund to [debtor]. Due to the [debtor's] breach of contract, the [debtor] does not have any legal or equitable interest in the fund. Accordingly, the fund is not the property of the estate.[30]

These contractual rights are bargained for by the government or private owner and are a significant property right, promoting the successful completion of the project. There is no provision of the bankruptcy code, nor any federal or state law, which would allow the bankruptcy trustee, a debtor's surety or a secured lender to eliminate these contract rights by the owner. The general contractor simply has no rights to a contract balance unless and until all subcontractors have been paid. It is on this theory, that many bankruptcy courts determine that a contract balance held by an owner is not "property of the estate."[31]

Other bankruptcy court cases, however, have found that an equitable lien exists and that contract funds are not property of the estate, even without discussion of contract provisions.[32]

Whether the contract balance is "property of the estate" may be a procedural distinction without a difference. A fund will have to be paid into the bankruptcy court if it is property of the estate. This will increase the bankruptcy trustee's commission, but should not affect the final result. The equitable lien claimant would stand in the same position as any other secured creditor, with a priority right to distribution of funds out of the bankruptcy estate. It is apparent that the equitable lien claimant would have priority in this fund, even over other secured creditors with an assignment or security interest in the same funds. It is probably the correct answer, however, and is a preferable procedure for a claimant that the fund go directly to the claimant and not through the bankruptcy estate. At a minimum, this would mean faster payment and will reduce the risk of competing claims to the fund.

H. Sureties and Subrogation Issues

Equitable lien theory has historically been an extremely important vehicle for a payment or performance bond surety.[33] Much of the equitable lien case law actually involves a surety making claim to a contract balance in the hands of the government.

A surety will claim a contract balance from a property owner on the theory of "subrogation." If a surety is required to pay a claimant under a payment or performance bond, the surety acquires the rights of the claimant that the surety paid. This is an equitable concept, not dependent on any contractual provision.[34]

If a surety pays a subcontractor in full, the surety can then seek reimbursement by enforcing any rights the subcontractor had, including enforcing an equitable lien against a contract balance held by an

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(*Continued from page 11*)

owner. As we discussed above, however, a subcontractor has no right to enforce this equitable lien against a government owner, because of sovereign immunity.[35]

The surety is also subrogated to the rights of the general contractor, however. The general contractor is in direct privity of contract with the government and does have the right to sue the government. On this theory, federal courts have allowed a surety to enforce equitable lien rights of the subcontractors, even though the subcontractors would be barred from enforcing these rights themselves because of sovereign immunity.

A surety has better rights than a subcontractor with this ability to avoid sovereign immunity problems. Otherwise, however, the surety's rights cannot be stronger than the subcontractor's rights. As discussed above[36], the equitable rights of unpaid subcontractors in retained funds are superior to the equitable rights of a surety that had paid other subcontractors.

> [t]he sureties' claims arose because the sureties' were subrogated to the rights of the suppliers and laborers. Any rights held by the sureties' were founded upon the rights of the unpaid laborers and suppliers. . . . We would hardly hold that a subrogee [i.e. the Sureties] may enforce a right after becoming subrogated to it, but that the original owner of the right [i.e. the subcontractors] may not enforce the right before the subrogation occurs.

In fact, as discussed above, an unpaid subcontractor will win a battle with a surety for priority over a fund held by an owner.[37] Under the settled law of surety ship, the surety is not subrogated to the subcontractor claimants' rights until those claimants have been paid in full.[38]

I. Providing Notice of the Equitable Lien

It may be important for an equitable lien claimant to provide notice of their equitable lien claim at an early stage. As in any construction contract case, the earlier an owner is aware of a dispute, the earlier the owner can and will began to hold funds to protect the owner's interest as well as the subcontractor's. In most cases, it will be considerably easier to amicably resolve a dispute if a fund for payment is preserved.

It also makes sense that there is a "defense of payment" feature to an equitable lien claim.[39] Once the owner has paid everything owed to a general contractor, there can be no equitable lien claim against funds in the hands of the owner. There may be an ability to trace funds and enforce rights against third parties,[40] but there will be no claim against the owner.

In at least one case, an owner was exposed to double liability and required to pay an equitable lien claimant after the owner ignored a notice of equitable lien and made payment to others.[41] Accordingly, owners and general contractors should take notice of any equitable lien seriously. By the same token any subcontractor will wish to send notice of their equitable lien at the earliest sign of trouble in a project to the project owner, general contractor, and if possible, any surety and secured lender.

Endnotes can be found on Page 15

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PLEADING THE PREFERENCE CLAIM: IS IT GETTING EASIER FOR THE BANKRUPTCY TRUSTEE?

(*Continued from page 3*)

The complaint alleged the facts that the defendant had an employment agreement with the debtor, and had been paid by the debtor during the one year preference period.

The *Webvan* court noted that dismissal of a preference complaint for failure to state a claim is a drastic remedy. The court observed that it is required to accept all of the allegations in the complaint as true, and draw all reasonable inferences in the light most favorable to the plaintiff trustee. Further, the court must take the facts alleged in the complaint as true, and that the transfers made to the defendant, are transfers to a creditor, on account of an antecedent debt, while the company was insolvent, within one year prior to the petition date, and received more than it would have under Chapter 7.

The *Webvan* court found that the trustee had set forth a claim upon which relief may be granted. In reviewing Federal Rules of Civil Procedure 8(a)(2), the court found that FRCP does not impose a heightened pleading standard on a preference claim, only that it requires a short and plain statement of the claim showing that the pleader is entitled to relief.

The *Webvan* court expressly rejected the heightened pleading standard imposed on the bankruptcy trustee in preference cases set forth in *TWA v. Marsh USA, Inc.*, 2004 WL 180421 (Bankr. D.Del. 2004) and *Valley Media Inv. v. Borders, Inc. (In re Valley Media, Inc.)*, 288 B.R. 189 (Bankr. D.Del. 2003). The *TWA* and *Valley Media* courts imposed the following pleading threshold for a preference claim: (1) plead the nature and amount of each debt; and (2) identify each transfer, including date, name of debtor and transferee and the amount of the transfer.

Although the trustee should provide specific facts at the pleading stage when available, the *Webvan* court observed that requiring such information at the pleading stage is a heavy burden given the time constraints for filing preference actions and the uncertain condition of the debtor's books and records. The Webvan court was also concerned that by imposing a higher pleading standard the valuable claims of the estate could be lost, resulting in the estate losing preference recoveries. The creditor's motion to dismiss the preference action was denied.

While the creditor was unsuccessful in the *Webvan* case in having the preference action dismissed, the credit professional should consider attacking the preference suit at the pleading stage. Perhaps the credit professional may find a court adopt a heightened pleading standard as set forth in the *TWA* and *Valley Media* decisions.

RECLAMATION DEMAND AGAINST CUSTOMER THAT LATER FILES BANKRUPTCY SHOULD BE IN WRITING -- OR RISK PREFERENCE ACTION

(*Continued from page 3*)

2-702 of the Uniform Commercial Code (UCC). The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor was defrauded. Under the common law and the old Uniform Sales Act, the seller could only exercise its reclamation rights if it proved the buyer obtained delivery by misrepresenting its solvency. However, the UCC has expanded this remedy where the buyer does not misrepresent solvency. If the debtor has misrepresented its solvency in writing within three months before delivery, the ten day demand period does not apply.

What is the effect of a vendor's right of reclamation upon a debtor's bankruptcy filing? The requirements for reclaiming goods under state law (Article 2 of the UCC) differ from a vendor reclaiming under bankruptcy law. In most states, a demand to reclaim under Article 2 of the UCC need only be made within ten days after delivery of goods. Bankruptcy Code section 546(c) requires that a reclamation demand be in writing.

The Vendor Reclaims Goods

In *Zeta Products,* a vendor shipped goods to the debtor on credit. The debtor failed to pay on time. The vendor orally demanded return of the goods. The vendor repossessed the goods. Within 90 days of reclamation, the debtor filed Chapter 11 bankruptcy. The debtor investigated all payments it had made to vendors within the 90 days prior to the bankruptcy filing, including the debtor's return of any goods to vendors.

The Trustee Sues The Reclaiming Vendor For A Bankruptcy Preference

The debtor sued the vendor for a preference contending that the vendor failed to comply with the reclamation provisions of the Bankruptcy Code as the vendor reclaimed the goods from the debtor by making an *oral* reclamation demand. The vendor argued that it repossessed the goods in compliance with Article 2 of the UCC, as it had made a demand on the debtor for return of the goods within ten days after they were received.

The Bankruptcy Preference Laws

The Bankruptcy Code vests the debtor (or trustee if one is appointed) with far-reaching powers to recover nearly every transfer of assets by a debtor 90 days prior to a bankruptcy filing (one year for an insider). The Bankruptcy Code's definition of a preferential transfer is broadly construed by courts to include the transfer goods from the buyer (debtor) back to the vendor. The question for the court was whether the oral reclamation demand was a sufficient form of reclamation demand given the debtor had filed bankruptcy within 90 days of the reclamation.

The Reclamation Is A Preference

The court noted that the requirements for demanding reclamation under state law differ from those under the Bankruptcy Code. The court held that Bankruptcy Code section 546(c) supersedes Article 2 of the UCC and requires that a vendor's reclamation demand be in writing: "[i]n the context of a bankruptcy proceeding, only a written demand will suffice to preserve the seller's immunity from the trustee's avoiding powers."

The court concluded that as the reclamation demand was not in writing, and that the reclamation was made during the preference period, the vendor lost the shield of immunity provided by the Bankruptcy Code's reclamation provision and the reclamation was an avoidable preference.

Your Reclamation Demand Should Be In Writing

The bankruptcy court in *Zeta Products* reminds vendors that a reclamation demand should be in writing even if the debtor has not filed for bankruptcy. Below is a form of reclamation demand letters a vendor may consider sending to an insolvent debtor, prior to bankruptcy and in bankruptcy.

NON-BANKRUPTCY RECLAMATION DEMAND LETTER

[*date*]

VIA FACSIMILE AND OVERNIGHT MAIL *[OR, HAND DELIVERY]*

[*Debtor*]

Re: **[*Debtor's Case Name*]**

Dear **[*Debtor's Officer*]**:

This letter constitutes a notice of demand for the return of certain goods purchased by the above-captioned debtor ("Debtor") from **[*Creditor*]** (the "Seller"). Please take notice that pursuant to **[*State*]** Commercial Code 2702, and by virtue of the Debtor's insolvency, the Seller hereby demands the segregation and return of all the ***[Reference goods]*** (the "Goods") currently in your possession and delivered to you on or after **[*Delivery Date*]** pursuant to the invoices, dated **[*Invoice Date and Invoices Numbers. Invoices may be attached*]**. Unless you authorize the return of the Goods immediately, further appropriate measures will be taken.

Please contact the undersigned immediately to make arrangements to allow the Seller to reclaim the Goods. I look forward to hearing from you shortly.

Sincerely,

[*Credit Executive*]

EXHIBIT "A"

(*Continued on page 14*)

RECLAMATION DEMAND AGAINST CUSTOMER THAT LATER FILES BANKRUPTCY SHOULD BE IN WRITING -- OR RISK PREFERENCE ACTION

(Continued from page 13)

BANKRUPTCY RECLAMATION DEMAND LETTER

[*date*]

VIA FACSIMILE AND OVERNIGHT MAIL *[OR, HAND DELIVERY]*

[*Debtor*]

Re: **[*Debtor's Case Name*]**

Dear **[*Debtor's Officer*]**:

This letter constitutes a notice of demand for the return of certain goods purchased by the above-captioned debtor ("Debtor") from **[*Creditor*]** (the "Seller"). Please take notice that pursuant to **[*State*]** Commercial Code 2702, 11 U.S.C. section 546(c), and by virtue of the Debtor's insolvency, the Seller hereby demands the segregation and return of all the ***[Reference goods]*** (the "Goods") currently in your possession and delivered to you on or after **[*Delivery Date*]** pursuant to the invoices, dated **[*Invoice Date and Invoices Numbers. Invoices may be attached*]**. Unless you authorize the return of the Goods immediately, further appropriate measures will be taken.

Please contact the undersigned immediately to make arrangements to allow the Seller to reclaim the Goods. I look forward to hearing from you shortly.

Sincerely,

[*Credit Executive*]

EXHIBIT "B"

EQUITABLE LIENS – ENDNOTES

1 In re RAH Development Co. Inc., 184 b.r. 525 (W.D. Mich. 1995), ftn 3.
2 Ibid. The distinction may have at least procedural significance, however, in determining whether the fund is ever part of a bankruptcy estate pursuant to 11 U.S.C. §541.
3 United States v. Munsey Trust Co., 332 U.S. 234, 240, 67 S.Ct. 1599, 1602 (1947).
4 Framingham Tr. Co. v. Gould- National Batteries, 427 F.2d 856, 858 (1st Cir. 1970), citing Munsey Trust, Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); National Surety Corp. 133 F.Supp. 381, 384, 132 Ct.Cl. 724, cert. Denied, 350 U.S. 902, 76 S.Ct. 181, 100 L. Ed. 793 (1955) and Pearlman v. Reliance Insurance Co, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).
5 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987), citing Restatement of Security § 141 (1941); Id. § comment (e); See Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); Matter of Dutcher Construction Corp., 298 F.2d 655, 658 (2d Cir.) (quoting National Surety Corp. v. United States, 133 F.Supp. 381, 384, 132 Ct.Cl. 724, cert. Denied, 350 U.S. 902, 76 S.Ct. 181, 100 L.Ed. 793 (1955)), aff'd sub nom. Pearlmen v. Reliance Insurance Co., 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).
6 Prarie Bank, Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); Munsey Trust, 332 U.S. 234, 240, 67 S.Ct. 1599, 1602 (1947); Pearlman v. Reliance Insurance Co, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962). For a good discussion of the history of these cases See In re RAH Development Co. Inc., 184 B.R. 525 (W.D. Mich. 1995). Most of these cases concern the subrogation rights of performance and payment bond sureties, but the sureties in those cases could not have equitable liens in contract balances held by the government unless the subs and suppliers paid by the sureties had that same equitable lien. See Pearlman v. Reliance Insurance Co., 371 U.S. 132, 137, 83 S.Ct. 232, 9 L.Ed. 2d 190, 197 F.Supp. 441 (W.D. NY 1961). See also Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987). See also subsection below on Sureties and Subrogation Issues.
7 F.D. Rich v. Industrial Lumber Co. Inc., 417 U.S. 116 (1974); U.S. For Use of JB Systems v. Federal Ins. Co., 8 F. Supp.2d. 1320 (M.D.Ala. 1998).
8 See section below, Quantum Meruit and Unjust Enrichment.
9 Tradesman International Inc. v. U.S. Postal Services, 234 F.Supp. 1191 (Kan. 2002).
10 Aspen - Fifty State Construction Lien and Bond Law § 1.09 *When Contractor Does Not Provide Bond* (Aspen 2002).
11 United Electric Corp. v. US, 647 F2nd 1082, (Ct. Cl. 1981).
12 United Electric Corp. v. US, 647 F2nd 1082, (Ct. Cl. 1981).
13 In re Pyramid Industries, Inc., 170 B.R. 974 (N.D. Ill. 1994); In re Pyramid Industries, Inc., 210 B.R. 445 (N..D. Ill. 1994); In re RAH Development Co. Inc., 184 B.R. 525 (W.D. Mich. 1995).
14 Automatic Sprinkler v. Darla Engir. Spec., 53 F.3d 181 (7th Cir. 1995).
15 See chapter above Trust Funds, section, Trust Fund Theory, subsection, Involuntary Trustees.
16 Ashworth v. Hagan Estates, 165 Va. 151 (1935).
17 Matter of RAH Development Co. Inc., 184 B.R. 525 (W.D. Mich. 1995); In re Pyramid Industries, Inc., 210 B.R. 445 (N.D. Ill. 1994); See also US v. TAC Construction Co., 760 F.Supp. 590 (S.D. Miss. 1991). These battles sometimes take the form of a subrogated surety against a secured creditor. The subrogated surety in such cases consistently have priority over the secured lender, which would indicate that unpaid subcontractors have priority over secured lenders as well.; See National Surety Corp. v. United States, 133 F.Supp. 381 (Ct. Cl. 1955); In re Pacific Marine Dredging & Construction v. Tri-City Service District, 78 B.R. 924 (Or. 1987); Framingham Tr. Co. v. Gould- National Batteries, 427 F.2d 856 (1st Cir. 1970).
18 In re Pyramid Industries, Inc., 170 B.R. 974 (N.D. Ill. 1994) [Case Below]; In re Pyramid Industries, Inc., 210 B.R. 445 (N.D. Ill. 1994), citing US v. TAC Construction.
19 Kennedy Electric Company, Inc. v. United States Postal Service, 508 F.2d 954 (10th Cir. 1974).
20 Framingham Tr. Co. v. Gould- National Batteries, 427 F.2d 856 (1st Cir. 1970).
21 Tradesmen International v. Lockheed Martin Corporation, 241 F.Supp.2d 1337 (Kan.2003).
22 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987)
23 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987).
24 In re Pacific Marine Dredging & Construction v. Tri-City Service District, 78 B.R. 924 (Or. 1987).
25 Bethlehem Steel Corp. v. J. Coleman, 66 B.R. 932 (M.D. Ga. 1986); Georgia Pacific Corp. v. Sigma Service Corp., 712 F. 2d 962 (5th Cir. 1983); In re Modular Structures, Inc., 27 F.3D 72 (3rd Cir. 1994).
26 In re Modular Structures, Inc., 27 F.3D 72 (3rd Cir. 1994).
27 Bethlehem Steel Corp. v. J. Coleman, 66 B.R. 932 (M.D. Ga. 1986); Georgia Pacific Corp. v. Sigma Service Corp., 712 F. 2d 962 (5th Cir. 1983).
28 In re Pacific Marine Dredging & Construction v. Tri-City Service District, 78 B.R. 924 (Or. 1987). Framingham Tr. Co. v. Gould- National Batteries, 427 F.2d 856 (1st Cir. 1970); In re Modular Structures, Inc., 27 F.3D 72 (3rd Cir. 1994).
29 48 C.F.R. 52.232-5 (2003).
30 In Re Pacific Marine Dredging & Construction, 79 B.R. 924, 929 (Bankr.D.Or.1987). See also In re Modular Structures, Inc., 27 F.3D 72 (3rd Cir. 1994). It is on this theory that bankruptcy courts often determine that a contract balance is not "property of the estate." See chapter below Bankruptcy Primer for Creditors, section, Preferences.
31 In re Modular Structures, Inc., 27 F.3D 72 (3rd Cir. 1994); Polish v. Johnson Service Company, 333 F.2d 545 (3rd Cir. 1964); In re Pacific Marine Dredging & Construction v. Tri-City Service District, 78 B.R. 924 (Or. 1987); See contra In re Matter of RAH Development Co. Inc., 184 B.R. 525 (W.D. Mich. 1995) where the bankruptcy court found that an equitable lien existed, but that the funds had to be paid into and administered by the bankruptcy court, because the fund was property of the estate. While this reasoning is questionable and not in accordance with other cases, it may be a procedural distinction without a difference.
32 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987); National Surety Corp. v. United States, 133 F.Supp. 381 (Ct. Cl. 1955); United Electric Corp. v. US, 647 F.2d 1082, (Ct. Cl. 1981).
33 Pearlman v. Reliance Insurance Co., 9 L.Ed. 2d 190, 197 F.Supp. 441 (W.D. NY 1961); Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908).
34 American Nat'l Bank & Trust Co. v. Weyerhaeuser Co., 692 F.2d 455,460 (7th Cir. 1982).
35 Depart. Of Army v. Blue Fox, Inc., 525 US 255 (1999); Blue Fox v. Small Bus. Administration, 121 F.3d 1357 (9th Cir. 1997); Tradesmen International, Inc. v. US Postal Service, 234 F.Supp.2d 1191 (Kan. 2002); U.S. v. TAC Constr. Co., Inc., 760 F. Supp. 590 (S.D.Mmiss. 1991); But see Kennedy Electric Company, Inc. v. United States Postal Service, 508 F.2d 954 (10th Cir. 1974).
36 See subsection above, Sureties and Subrogation Issues.
37 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987).
38 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987).
39 See chapter above, General Mechanic's Lien Principles and multiple chapters above on Mechanic's Liens in Virginia, Maryland, Pennsylvania and D.C., section, Defense of Payment.
40 See chapter above, Trust Funds, section, Trust Fund Theory, subsection, Tracing and Identifying Funds.
41 Active Fire Sprinkler Corp. v. US Postal Serv., 811 F.2d. 747 (2nd Cir. 1987).

RECENT ENGAGEMENTS AND ACTIVITIES

Blakeley & Blakeley LLP Recent Engagements and Activities for Summer 2004

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

- ◊ Scott spoke to the ***National Electrical Distributors Credit Association*** regarding **Creditors' Rights**.
- ◊ Scott spoke to the ***NACM/Chicago-Midwest National Agricultural Credit Conference*** in Las Vegas regarding **Creditors' Rights**.
- ◊ Scott spoke to ***FCIB Global*** in Chicago regarding the **Sarbanes Oxley Act.**
- ◊ Scott spoke to the ***NACM Houston's National Motor Carriers Group*** in San Francisco regarding **Recent Developments with Creditors' Rights and Bankruptcy.**
- ◊ Scott spoke at the ***CMA Business Credit Association Annual Meeting*** regarding the **Sarbanes Oxley Act.**
- ◊ Scott spoke to ***NACM/Kansas City's Athletic Shoe Industry Group*** in San Diego regarding the **Sarbanes Oxley Act and Escheatment.**
- ◊ Scott spoke at the ***IOMA Teleconference*** regarding **Creditors' Rights.**
- ◊ Scott spoke at the ***BPCA Credit Conference*** in Phoenix regarding **Credit Enhancements**.
- ◊ Scott spoke to ***NACM/Chicago-Midwest's Housewares Group*** regarding the **Sarbanes Oxley Act.**
- ◊ Scott spoke at ***Ferguson Enterprises Annual Controllers' Meeting*** in San Diego regarding the **Sarbanes Oxley Act**.
- ◊ Scott spoke to ***NACM's Credit Congress*** in Phoenix regarding the **Sarbanes Oxley Act**.
- ◊ Scott spoke to ***NACM/Tampa's Book Publishing Group*** in Phoenix regarding **Escheatment**.
- ◊ Scott spoke to ***NACM/Mid-Atlantic Pharmaceutical Credit Group*** in Phoenix regarding the **Sarbanes Oxley Act**.
- ◊ Scott spoke at the ***What's Working in Credit Teleconference*** regarding **Credit Enhancements**.
- ◊ Scott spoke to the ***Orange County Credit Professionals*** regarding the **Sarbanes Oxley Act**.
- ◊ Scott spoke to ***NACM/Chicago-Midwest Housewares Industry Group*** regarding the **Sarbanes Oxley Act**.
- ◊ Scott spoke to ***NACM/Kansas City's Food Manufacturer's Credit Group*** in Chicago regarding the **Sarbanes Oxley Act**.

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