

THE TRADE VENDOR QUARTERLY

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

RECLAMATION DEMAND AGAINST BANKRUPT DEBTOR SHOULD BE IN WRITING -- OR RISK PREFERENCE ACTION

Scott Blakeley



You ship on open account, the debtor receives the goods and fails to pay according to invoice. What to do? Article 2 of the Uniform Commercial Code provides that a vendor may recover possession of goods delivered to an insolvent buyer. 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 re M.P.G., Inc.*, 222 B.R. 862 (*Bankr. W.D. Ark.* 1998), recently ruled that a vendor reclaiming goods based on an oral reclamation demand -- not in writing -- 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 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 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© requires that a reclamation demand be in writing.

The Vendor Reclaims Goods

In *In re M.P.G., Inc.*, a vendor shipped goods to the debtor on credit, with payment due in one week. The debtor failed to pay on time. The vendor orally demanded return of the goods. The vendor repossessed the goods and sold them. Within 90 days of reclamation, the debtor filed Chapter 11 bankruptcy. A Chapter 11 trustee was appointed and investigated all payments made by the debtor 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 bankruptcy trustee sued the vendor for a bankruptcy 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

(continued on page 6)

CONTENTS

Reclamation Demand Against Bankrupt Debtor	1
Is Your Guarantor <i>Personally</i> Guarantying	2
Proofs of Claim In Bankruptcy	3
Battling For Payment	3
Check Your Voice Mail	4

IS YOUR GUARANTOR REALLY PERSONALLY GUARANTYING THE CREDIT SALE?

Scott Blakeley

A personal guaranty is a common requirement by a credit professional to reduce credit risk with a sale to a corporate debtor. A party, usually a principal of the company purchasing the goods (the guarantor), states to the vendor that if the vendor will sell the corporate debtor on credit, the guarantor will guarantee the payment. This promise to pay by the guarantor is an inducement for the vendor to sell the debtor on open account and the guaranty creates a contract of secondary liability.

A personal guaranty often is perceived by the credit professional to have questionable collectability. However, the personal guaranty may assure payment on the open account where a debtor is in financial straits and is unable to pay all vendors. The personal guarantor will likely direct the corporation to repay those debts that are not personally guaranteed to remain unpaid, to avoid personal lawsuits for collection of the personally-guaranteed debt.

A credit executive must take certain steps to ensure he or she has a valid guaranty to avoid unnecessary legal attacks by the guarantor. A recent case from the Court of Appeals for the state of Georgia¹ illustrates where a form guaranty was sufficiently ambiguous to open the door for the personal guarantor to challenge whether the vendor held a valid guaranty.

A Guaranty From The President?

In *Dewberry*, an individual who was the president of a company, guaranteed the company's open accounts with the vendor. The individual signed the guaranty and added the title "President" after his signature. The president's company name was typed in above the individual's signature line.

The printed words "personal guarantee" were crossed out from the credit application.

The guaranty form referred to the guar-

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

antor only as the "undersigned":

"In consideration of your extending credit to the [vendor] and in consideration of the receipt of certain materials by said firm, we the undersigned do hereby jointly and severally guarantee the payment by said firm."

The debtor company defaulted on the open account. The vendor sued the individual in his personal capacity on the guaranty. The vendor filed a motion for summary judgment, looking to hold the guarantor liable without going to trial on the lawsuit. The guarantor asserted he had not personally obligated himself to the agreement as he had signed the guaranty in a representative capacity (as president for the related company).

The court framed the issue as whether a person using a representative title (for example, president) prevents a signer from becoming personally bound under a guaranty.

Principles of Contract Control

In *Dewberry*, the guaranty did not name the individual guarantor. The guaranty

stated that the party signing was to be personally bound, but the pre-printed words were crossed out. The general rule is that when the signer's identity is otherwise clear from the face of the contract, the title appearing after the signature is merely a personal descriptor, and does not prevent personal liability from attaching. However, the individual guarantor typed in the debtor company name above the signature line and typed in "President" below the signature line.

The court found that guarantor did not sign the guarantee in a personal capacity and was not personally obligated for purposes of the summary judgment ruling. The court of appeals reversed the trial court. The court noted that the vendor may be able to establish personal liability of the guarantor, however, that must wait until trial.

Is Your Guaranty Complete?

As credit executives are well aware, a guarantor will always attempt to find ways to challenge the validity of his or her guaranty. The *Dewberry* court case reminds credit executives that the guarantor is not a party to the principal debt. The guarantor's undertaking is independent of the debtor's promise to pay. Merely because both contracts are on the same paper -- the debtor's promise to pay for the vendor's goods or services, and the guarantor's promise to pay if the debtor does not -- does not change the independence of the agreements.

Using a form guaranty that fails to identify the guarantor and the capacity that the guarantor is signing may open the door for needless legal challenge by the guarantor, which adds to the delay and expense for the vendor. The guaranty should include a statement that the signing party is personally guarantying the debtor of the enterprise referenced in the credit application. The guaranty should have under the signature block a line for the individual guarantor's social security number and a line for the individual guarantor's home address. The guarantee should be signed before a notary to reduce the risk that guarantor may contend that the guarantee was forged.

1. *Dewberry Painting Centers, Inc. v. Duron, Inc.*, 235 Ga.App. 40 (1998).

PROOFS OF CLAIM IN BANKRUPTCY

Scott Blakeley

Barry P. Caplan¹

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 for the creditor to give formal notice of the amount claimed to the bankruptcy court, the debtor, the trustee (if one is appointed) and other creditors of claims against the estate. The Bankruptcy Code and Rules spells out specific requirements in order 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 claim can be disastrous for the credit executive, as a late-filed claim effectively eliminates any distribution.

I. PROOFS OF CLAIM: THE WHO'S, WHEN'S AND WHERE'S

The Bankruptcy Rules set different filing requirements of a creditor's proof of claim depending on whether the debtor has filed a Chapter 11, Chapter 7 or Chapter 13 bankruptcy petition.

A. Chapter 11 Bankruptcy

Chapter 11 of the Bankruptcy Code provides for the reorganization of a debtor's assets and liabilities, and existing management continues to operate the business. 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 list all of its

prepetition debts in its schedules. If a creditor agrees with the debtor's scheduled amount of its claim, and the claim is not listed as disputed, contingent or unliquidated, a creditor need not file a claim. However, a debtor may schedule a creditor's claim as disputed, contingent or unliquidated by checking a small box contained on the schedules next to the creditor's claim. An unsecured creditor whose claim is scheduled as disputed, contingent or unliquidated must file a claim by the bar date, or the claim will be subordinated to the unsecured creditor class, which means the claim, as a practicable matter, will be disallowed. A devious debtor could schedule all of its unsecured claims as disputed, contingent or unliquidated in hopes that creditors will not file proofs of claims. It is always a safe practice to file a proof of claim in a Chapter 11; often the debtor's schedules will not correctly list the amount of the debt.

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. The late-filed claim is treated as 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 within the first 120 days of the Chapter 11. It is a good practice to file a proof of claim as quickly as possible.

3. Where A Claim Must be Filed

A creditor must file its claim with the bankruptcy court that is administering the Chapter 11 case. For example, if the case is pending in the Central District of California, the claim must be filed in that District,

(continued on page 5)

BATTLING FOR PAYMENT: TRACING YOUR PURCHASE MONEY SECURITY INTEREST PROCEEDS

Scott Blakeley

One mandate imposed on a credit professional is to assist in "making the sale" - but address the credit risk of an open account sale, an aspect of the sale the salesperson may ignore or downplay. A credit professional is well aware of the variety of risks of non-payment or delay when selling on open account. One method a credit executive may reduce or eliminate such risk, and still "make the sale", is by taking a security interest in the merchandise they sell, and the identifiable proceeds from the sale of the goods. This type of security interest is called a purchase money security interest or "PMSI".

The credit executive that uses PMSI for their credit sale is familiar with the required steps to properly perfect their security interest in the goods and the identifiable proceeds. The court in *Textron Financial Corp. v. Firststar Bank of Wisconsin*¹ reminds a vendor that their PMSI may be challenged by a competing creditor and that they must trace the proceeds from the sale of their goods.

The Debtor Sells Collateral Subject to PMSI

The debtor had obtained loans from a lender that obtained a security interest in all of the debtor's assets (the blanket lien lender). The debtor also obtained collateral from a creditor that asserted a purchase money security interest in its collateral. The blanket lien lender perfected its security interest prior to the PMSI creditor. The PMSI creditor gave notice to the blanket lien lender of its security interest in the particular collateral it has supplied the debtor. The debtor sold the PMSI creditor's collateral and deposited the proceeds at an account maintained at the blanket lien lender. Shortly thereafter, the debtor failed to pay a portion of the PMSI creditor's

(continued on page 9)

CHECK YOUR VOICE MAIL (AND SOON YOUR E-MAIL) BEFORE CONTINUING COLLECTION EFFORTS, YOUR DEBTOR MAY HAVE FILED BANKRUPTCY

Scott Blakeley

An experienced credit professional is well aware of the extra effort it takes to squeeze payments from a debtor in financial straits who has defaulted on a credit line. Constant monitoring of the account, including phone calls, letters, and e-mails to remind the debtor that payment is overdue is some of the things that a vigilant credit professional undertakes. Unfortunately, some debtors are unable to work out their cash flow problems and are forced to file for bankruptcy.

A credit professional is also well aware that with a bankruptcy filing, whether a Chapter 7, 11 or 13 bankruptcy petition, whether an individual, partnership, corporation or LLC have filed, all collection efforts must immediately cease because of the automatic stay. Given that the automatic stay arises upon a debtor's bankruptcy filing, how does the credit professional learn of a debtor's bankruptcy filing so as not to violate the automatic stay? In a recent bankruptcy case, *In re Cepero*¹, a creditor who received voice mail from the debtor advising of the bankrupt filing but continued collection efforts was found to have wilfully violated the automatic stay and sanctioned. The court's decision and an overview of the automatic stay is considered.

Creditor's Efforts to Collect on the Delinquent Account

In *In re Cepero*, a creditor repossessed its collateral from the debtor prebankruptcy. The creditor gave notice to the debtor that it proposed to sell the collateral. Three days before the proposed sale, the debtor filed bankruptcy apparently to stay the sale. The

debtor's counsel left several phone mail messages with the creditor's collection representative advising of the bankruptcy filing, of the proposed sale date and that the sale must stop. The creditor did not respond. After the repossession sale date, the debtor's counsel finally reached the creditor's collection representative who advised that the voice mails had been forwarded to the creditor's representative responsible for bankruptcy filings. The debtor never forwarded any written notice to the creditor of the bankruptcy filing. The court general notice to creditors of the bankruptcy filing was not sent until after the repossession sale. The bankruptcy representative advised that she had received the voice mails but had been exceptionally busy and did not respond until after the repossession sale.

Debtor Claims Damages For Violation Of Stay

The debtor contended that the creditor willfully violated the automatic stay by selling the collateral after receiving notice of the bankruptcy filing. Because the debtor was an individual, the debtor requested actual damages, including attorneys' fees and punitive damages. The creditor claimed that violation of the automatic stay was not willful, as it did not have adequate or actual notice of the bankruptcy filing at the time of the repossession sale.

The Automatic Stay: Anything Worth Doing Is Stayed

The automatic stay is an injunction which automatically and immediately goes into effect as soon as a bankruptcy case is filed, whether the bankruptcy filing is one under Chapter 7, 11 or 13, whether the case was commenced as an involuntary bankruptcy. The stay is automatic in the sense that it arises automatically upon filing the bankruptcy case by operation of law, without the bankruptcy court having to enter an order stating that it exists. The stay is in effect even where the creditor has not been given notice that the bankruptcy case has been filed.

The automatic stay prohibits any creditor from taking action against the property

of the estate and against the debtor, unless relief from stay is obtained. For example, a vendor is barred from seeking or levying writs of attachments or garnishments, and also stays the vendor from a judicial lien against the debtor, but has not yet levied on any property. The stay also enjoins secured creditors from repossessing or selling collateral. The purpose of the automatic stay is to give the debtor breathing room, and to protect creditors from each other by preserving the bankruptcy estate intact until property can be distributed according to the bankruptcy priority scheme and allow orderly administration of the case. The scope of the automatic stay is so broad that any action to collect is probably stayed. The debtor cannot modify the stay without the bankruptcy court modifying the stay and creditors having the opportunity to comment.

Voice Mail Sufficient Notice of Bankruptcy Filing

The court found that despite the appropriate prebankruptcy repossession, the creditor violated the automatic stay by failing to stop the sale postpetition. The court found multiple violations of the automatic stay. The court's question as to whether to award the debtor a damage award was whether the creditor had wilfully violated the automatic stay. The court found that the debtor's counsel's repeated voice mails provided notice to the creditor of the debtor's bankruptcy filing:

There is no basis to assert that the notice to [creditor] of Debtor's bankruptcy filing was insufficient because it was provided telephonically. In light of the proximity of the proposed auction sale . . . to the date of the bankruptcy filing, this Court finds that sufficient notice of the bankruptcy filing was provided to [creditor] from the office of the Debtor's counsel. The argument that the violation of the automatic stay was not willful since [creditor] was too busy to check her messages in a timely manner is spurious, and offensive to the Court. Notice of this bankruptcy filing was adequately provided when the legal assistant in the office of Debtor's counsel left telephone messages for the representative of the [creditor] identified as being responsible for re-

PROOFS OF CLAIM IN BANKRUPTCY (Continued)

(continued from page 3)

not the Northern, Eastern or Southern District of California. 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 Bankruptcies

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 to work out of their financial difficulties by paying creditors over time, discounting them, or both.

1. Who Must File

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

2. When A Claim Must be Filed

With an individual Chapter 7 case, the bankruptcy court will send written notice that creditors need not file a claim unless assets are recovered. If that occurs, notice to file is given when the case is declared an "asset" rather than a "no asset" case. Unless a "no asset" Chapter 7 case, with a Chapter 7 or Chapter 13, a creditor must file a claim within 90 days after the First Meeting of Creditors. Here, too, late-filed claims are treated as subordinated 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.

II. FORM OF PROOF OF CLAIM

A. The Contents and Purpose of Formal Proof of Claim

The formal proof of claim is Official Form 10. The Form is amended periodically, but the current version will normally be sent to all listed creditors in a bankruptcy proceeding along with the notice. A formal proof of claim must contain the following: the name of the 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.

B. Informal Proofs of Claim

Where a creditor 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 vital information that a formal proof of claim would provide (see "A" above), 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 first part of the test is met with the presentation of writings by the creditor, 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 creditor with counsel for the creditors' committee, conversations between the debtor and counsel for a creditor, 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 creditor to participate in a distribution of proceeds with like claims. Rather, a timely filed informal claim gives rise to an opportunity to amend the informal proof of claim 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 change in the amount of the claim does not constitute an untimely attempt to assert a new or different claim.

III. RELATIONSHIP BETWEEN PROOFS OF CLAIMS AND PREFERENCE CLAIMS: OTHER CONSIDERATIONS

A. Preferences

It is common that, in addition to the foregoing considerations, a credit executive will also need to expect that the trustee in a Chapter 7 case, or some appropriate party in a Chapter 11 case, will contend that prior payments made to the creditor were, in fact, avoidable preferences under 11 USC § 547. Therefore, the credit executive should also be considering issues of preference exposure, jurisdictional considerations and settlement leverage in deciding whether to file a proof of claim. If there is no reason to be concerned about preferences, the remainder of this section is not a factor for consideration in such cases.

B. Jurisdiction/Jury Trial

While it is not common, the credit executive should remember that, in a large

(continued on page 8)

**RECLAMATION DEMAND AGAINST
BANKRUPT DEBTOR SHOULD BE IN
WRITING -- OR RISK PREFERENCE
ACTION (Continued)**

(continued from page 1)

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© supersedes Article 2 of the UCC and requires that a vendor's reclamation demand be in writing:

"[state] law requires only that 'demand' to reclaim be made within ten days after delivery of the goods while section 546© of the Bankruptcy Code requires that written demand be made within ten days after delivery of goods. A majority of courts construe section 546© as the exclusive procedure for exercising the right of reclamation against a buyer who has previously filed for bankruptcy. Thus, under the majority view, a demand for reclamation must be in writing when the buyer is in bankruptcy."

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 *In re M.P.G., Inc.* reminds vendors that a reclamation demand should be in writing even if the debtor is not in 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"
BANKRUPTCY RECLAMATION DE-
MAND 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"

CHECK YOUR VOICE MAIL (AND SOON YOUR E-MAIL) BEFORE CONTINUING COLLECTION EFFORTS, YOUR DEBTOR MAY HAVE FILED BANKRUPTCY (Continued)

(continued from page 4)

possessions. The telephonic notification from the office of Debtor's counsel was sufficient to provide to provide [the creditor] with actual notice of the bankruptcy filing, despite the fact that it had not received written verification of the filing.²

The court sanctioned the creditor for violation of the stay, including awarding punitive damages to the debtor.

Stay Violation Has Teeth

The clerk of the bankruptcy court, or another party designated by the bankruptcy court, sends notice to all creditors scheduled by the debtor of the bankruptcy filing. Damages are assessed against a creditor only where it is shown that the creditor had notice or knowledge of the bankruptcy filing. Where there is a willful violation of the stay, the court will award a debtor actual damages, including a debtor's attorney's fees and costs for enforcing the violation. The court may also award punitive damages to punish the creditor.

Bankruptcy Notice In The Era Of E-Commerce

The *Cepero* court reminds credit executives that notice of a debtor's bankruptcy filing need not be a formal writing from the clerk of the bankruptcy court, but effective notice to a vendor may be via voicemail. The bankruptcy courts throughout the country are taking steps to keep abreast of technology. For example, in the near future, it is anticipated that bankruptcy courts will accept e-mailed filings. As e-mail becomes even more common as a means of communication, a credit executive may receive notice of a debtor's bankruptcy filing from the clerk of the bankruptcy court through e-mail. Until the courts advance to that point, remember, check your voice mail when chasing the delinquent account.

1. 226 B.R. 595 (S.D. Ohio 1998).
2. 226 BR. 598.

PROOFS OF CLAIM IN BANKRUPTCY *(Continued)*

(continued from page 5)

preference case, it may even be worthwhile to consider requesting a jury trial. (There is a split of authority whether such request is permissible; not all bankruptcy courts will grant a request for a jury trial.) To the extent the creditor has a right to request a jury trial, the mere filing of a proof of claim by the creditor will waive its right to a jury trial. Accordingly, if there is exposure to large preferences, this may be relevant to the decision of filing a proof of claim.

C. Settlement Leverage

In a Chapter 7 case, the sole fact that a proof of claim has been or will be accepted means there are assets in the estate. Theoretically, therefore, there may be a dividend paid at the end of the case. Although rare, there are some cases in which the dividend percentage is quite substantial. While defending a preference demand or lawsuit may be necessary and desirable, frequently it requires expense adding to the credit loss. The eligibility to participate in a dividend can facilitate a preference settlement. This may reduce the legal exposure plus eliminate the need for a double transfer of monies first to return the preference to the trustee or estate, and then later receiving a dividend. Often, months or even years pass before the dividend is received. Therefore, the ability to expeditiously dispose of both matters by settling the preference action and waiving the potential dividend may prove useful. This settlement potential is made available by filing a proof of claim.

D. Defenses

Filing a proof of claim with attached detail can sometimes be helpful in proving a defense to a preference. Normally, a proof of claim is accompanied by an itemized statement of account which will usually have information to support either an ordinary an course of business, or a new value defense or both.

E. When Not To File a Proof of Claim

If there has been significant payment in satisfaction of the debt within 90 days of bankruptcy, and it is clear that there will be a preference claim made, it may be best to not file a proof of claim. While normally the debtor and/or trustee will have all of the necessary information to pursue the preference, sometimes the debtor's records are incomplete or inaccurate, so the filing of a proof of claim hurts rather than helps the creditor. The decision needs to be reviewed based on the circumstances of each case.

F. Proof of Claim After Preference Recovery

Bankruptcy courts permit those creditors who are required to pay back a preference to the trustee or the estate, to therefore amend their proof of claim if one has already been filed, or to file a proof of claim within a short time period. Obviously, the proof of claim should be immediately amended or filed at that point in time to assure that the creditor shares in any future dividend from the case.

G. Other Possible Benefits or Burdens of Filing a Proof of Claim

1. By filing a proof of claim, a creditor becomes eligible to have its claim allowed. In order to participate in distribution of a debtor's assets in a case or under a plan, a claim or interest must be allowed.

2. Filing a proof of claim may also be necessary to vote in the election of a trustee or to receive notices. Not all bankruptcy courts require this. However, this is the technical requirement under Bankruptcy Rule 2003(b)3 which continued the practice under the Bankruptcy Act.

3. By filing a proof of claim, a creditor has submitted to the jurisdiction of the bankruptcy court. In addition, certain defenses might have been waived. This could be of greater significance to a taxing agency or governmental unit, i.e., sovereign immunity defense, than to a general creditor. However, there is authority that a creditor's withdrawal of its proof of claim is analogous to a voluntary dismissal of a lawsuit. Courts have held that, as a result, the creditor has voluntarily extricated itself from the bankruptcy court's equity juris-

dition. There could be cases in which a creditor would prefer not to be subject to the bankruptcy court's jurisdiction. In such cases a decision to not file a proof of claim (or to withdraw it) is in the creditor's best interest. This might be the case where there are complex contracts or claims or possible non-core proceedings which, from the creditor's standpoint, would best be heard outside of the bankruptcy court.

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BATTLING FOR PAYMENT: TRACING YOUR PURCHASE MONEY SECURITY INTEREST PROCEEDS (Continued)

(continued from page 3)

proceeds from the sale of its collateral. The debtor paid the proceeds to the blanket lien lender. The debtor filed bankruptcy.

PMSI Creditor Sues Blanket Lien Lender

The PMSI creditor sued the blanket lien lender, contending that the blanket lien lender received payments from the proceeds of collateral in which the creditor had a PMSI. The blanket lien lender contended that it was unaware that the proceeds were from the PMSI creditor's collateral. The bank claimed that the creditor lost its right to the proceeds when the debtor commingled the proceeds in its operating bank account.

Perfecting The PMSI Where There Is An Existing Secured Lender

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

As in the case in *Textron Financial*, a vendor must take special steps if it is claiming a PMSI in goods that will become inventory of the debtor and there is a preexisting inventory lender. Article 9 addresses conflicts between PMSI and inventory lenders:

“A perfected purchase money security interest in inventory has priority over a con-

flicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory of a buyer . . . “(emphasis added).

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

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

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

Tracing The PMSI Proceeds

Article 9 provides that a properly perfected PMSI extends to the identifiable cash proceeds of a sale of collateral subject to that security interest. In *Textron*, the PMSI creditor faced the battle to trace the proceeds from the sale of its collateral. The debtor placed a check representing the proceeds from the collateral into its operating bank account. Shortly thereafter, the debtor paid the bank from the operating account instead of the PMSI creditor. The bank argued that the money in the savings account was not identifiable cash proceeds from the sale of the PMSI creditor's collateral.

Article 9 requires the PMSI holder to identify its proceeds from the sale of its

collateral. The PMSI creditor must trace the claimed proceeds back to the original collateral, and that these proceeds could not have come from any other source. Where business records have been maintained, tracing proceeds into and out of an account can be simple.

The court determined that commingling the PMSI's creditor's funds in the lender's bank account does not necessarily defeat a PMSI in the proceeds. The PMSI creditor showed that the debtor had sold its collateral and the proceeds from the sale of its collateral was placed in the bank account.

Protecting Your Credit Sales

A vendor may find effective protection in a PMSI when selling on credit to a debtor that may be shaky financially. This protection for a vendor is complete only when the PMSI has been perfected, including perfecting an interest in the proceeds from the sale of the vendor's collateral. The *Textron* case reminds vendors to take precaution as to where the proceeds from the sale of your collateral ends up. A vendor may consider including in its security agreement a notice requirement that the debtor advise the vendor when its collateral is sold and tells the vendor where the proceeds will be deposited. Also, the vendor may consider requiring the debtor to establish an escrow account for the PMSI proceeds.

1. 579 N.W.2d 48 (Wis. Ct. App. 1998).