The Credit and Financial Management Review

A Journal for Credit and Financial Administrators

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At-A-Glance:
Develop correct legal language;
Avoid being shortchanged when it comes to new value;
Exercise your right of reclamation;
A credit manager's perspective on collections;
Positive solutions to the sales versus credit dilemma.

Strategies & Techniques

Legal Corner

The following four articles on guarantees, inferior products, personal gurantees, and preferences were written by David J. Cook, Cook, Perkiss & Lew, San Francisco. © 1996 David J. Cook, San Francisco, Calif. The material and opinions expressed are those of the author and are not intended to be a substitute for legal advice.

The Clever Customer

With a past due balance of $100,000, my largest customer defaults on payment. The customer signed the credit application and its principal signed a simplified form of a guaranty by only stating, "I guarantee payment of my company's bills," a form I abstracted from a credit magazine. Going out of business, the customer—a corporation—offers to pay the debt over a long-term payment program. I accept over the telephone. Did I make a mistake?

Signed,
Concerned.

Dear Concerned:
Did you commit the payment program to a written form? Payment programs mean that the customer has time to pay the bill. A payment program fixes the amount, the payment date, interest rate, and a due on a default clause, such as "in the event of default, the total is due." Try, "I owe you $100,000, payable $5,000 a month on the first of each month, 10 percent interest, all due on default."

Did the guarantor consent? No? Ugly. Alter the underlying debt by extension agreement or compromises and the guaranty is discharged, unless the guarantor waives this issue or consents in the guaranty.

Facing a total disaster from a large customer, we agreed to accept a return of our product, which was defective and stale dated. Refusing to credit the account, we dumped the stuff. Upon suit, the customer claimed that we waived any claim to reject this bad product. How could I get stuck with bad product as payment for the account?

Signed,
Unhappy Camper

Dear Unhappy:
Agreeing to accept product in payment on account, a wholesaler becomes a virtual buyer, subject to rules of prompt inspection, and if unacceptable, rejection (return) of the product. In rejecting the product, the wholesaler must notify the customer, preferably in writing, that the returned products are unacceptable and their return is rejected, and may proceed with a salvage sale. Different rules apply to perishables.

Rejection is only as good as notice, and absent notice, the wholesaler is stuck with the goods, no matter their condition. Return the product, or offer its return, which, if ignored, will permit you to sell the stuff.

I forgot to tell you that the returned product came with a letter which offered the return as full payment of the debt. Can I ignore this letter?

Signed,
Blissfully Uncertain

Dear Blissful:
Entering the world of psycho credit, the clever customer accompanies the product return with a letter stating that the products are returned in full satisfaction of the debt. If you take possession of the product with this letter, and fail to either refuse the return and bounce back the stuff, or reject the goods and hold them for return pick up, the customer can claim that the debt is discharged.

My lawyer advised me to write into my credit application a security interest, with the magic words, "customer agrees to grant a lien in all product sold by wholesaler to secure the purchase price." Stuck with a collection problem, I could repossess the product and become, a secured creditor. Sounds great. At a credit meeting, I learned something that a secured creditor (that's me) must sell the goods commercially and give notice to the customer and the guarantor. Are you serious?

Signed,
Repo Artist

Dear Repo:
Welcome to earth. A security interest means that you can seize your products and their proceeds. Assuming the credit application or invoice contains the security interest, the lien is junior (or worthless) to another creditor who filed a UCC. To enhance your position, add these words in the credit application: "You can sign my name to a UCC and file it." Sign the customer's name to a UCC and file with the secretary of state. Poof, you are now a perfected, secured creditor.

Have you achieved credit karma?

Yes and no. Your stuff is your collateral. This is helpful if you sell slow-moving steel; a dud, if you sell fish which turns quickly, either way. If the stuff is repo'ed, you must go through a documented, reasonable sale and notice to the customer and guarantor, or the debt evaporates. A return of $5.00 worth of product, recycled into inventory, without resale and notice vaporizes the balance of the debt. Beware of unwanted returns. The credit gods play with dice.

My customers forward checks marked "Payment in full," and hope to avoid the balance. Accompanying the checks, customer letters warn of financial demise or detail a dispute. I struck out the restrictive endorsement, deposited the check, and

sent the balance of the claim to a collection agency to sue, hopefully. But I lost in the end. How come?

Signed,
Lost in court
and not very happy

Dear Lost:
You lost because the law changed again. The old law said you could strike the restrictive endorsement, run the check through, and sue the customer for the balance.

Different and complex, the new law says if the customer sends you a letter which states conspicuously that the check is tendered as full payment, you are stuck if the check is cashed. Forget the business about striking the restrictive endorsement. To reach discharge for a lesser payment, the claim is genuinely disputed, the debtor is truly distressed, or the check pays a balance of a final account.

This rule has exceptions, as expected. If the wholesaler tells the customer in writing, in bold print that all communications go to one person (usually the credit manager) and the check does go to somebody else, who deposits the check, such as in a lock box, you win, and can sue for the balance. You can also send the money back in 90 days.

This story is not over yet. If prior to this escapade of check ping-pong, the wholesaler or its agent (usually the collection agency or attorney) knew that the check was tendered in full payment, the balance of the debt is destroyed. Warning: these rules are new.

How do we address these changes? Add to the credit application, invoices, and statement, in LARGE PRINT, (no kidding), "All communication concerning payments, disputes, settlements, and claims of damaged and defective products) must be directed solely to the credit manager in writing, within 10 days, or forever be waived. Forward all written communications and checks, 'Attention credit manager only.'"

Rather than file bankruptcy, the customer offers 50 cents on the dollar with a hard luck story and promises payment in 10 days. Instead of payment, the customer provides escrow instructions. Upon filing my claim for the total, not the 50 percent compromise, the customer rejects my 100 percent claim. Worse, the escrow is insolvent at 10 cents on the dollar.

Signed,
Stuck

Dear Stuck:
Accepting the 50 percent reduced your claim. Next time advise, "When you have the money at 50 percent, I'll consider it." Reject compromises unless the customer has money in hand. Keep your claim intact.

Coping with Bad Product Claims

The customer slowly takes the witness stand, ambling into the wooden chair. Counsel for the customer starts, "Was anything wrong with the product you bought from the wholesaler suing you now?" Taking a deep breath and eyeing the jury, the customer says, "Horrible products. Put me out of business. Worked all my life in that little shop."

Is this testimony the first notice that your company sold a defective product, allegedly? Upon hearing this news, do you look like a deer in the headlights or Dan Quayle at a press conference? Is your first response, "Huh? News to me. This customer never squawked about bad product claims."

Bad product claims come in two categories: Real and imagined. If real, the commercial law can quantify and limit the loss, and imagined, force the customer into an untenable position. To make it simple, this exercise starts with defective product claims and ends with the customer paying you. Neat trick, if successful.

Let's ignore the mundane claims resolved by sales people, who repair goods, allow credits, or take back the product. Sales people adjust the bills and close matters. The balance of product claims exceeds normal adjustments either because the product is a bomb or because the customer manufactures the claim to beat the debt. Only the superhero, the credit manager, will save the day, or alternatively, sink the ship. Life vests are extra.

From the top, the law says that the product must be merchantable (pass in trade, readily usable for normal purposes.) Some products come with warranties for a particular use or even expressed warranties, such as models, demonstrations, written specification or verbal claims by the sales or manufacturing representative. If the salesperson claims that moon rocks consist of green cheese, pray that your cheese machine works full time.

Bad product claims depend upon the grand pillars in commercial law: Notice and rejection. Conversely, product claims die a natural death if the customer either fails to promptly notify the seller of the bad product (i.e., soon, soon, and soon) or consumes the product in the normal course of trade. A customer cannot suffer, consume the product, and decline payment because the product was bad, absent extraordinary circumstances. Upon demanding the return of bad product, which never comes back, the customer resembles a cat who ate the canary.

The first line of defense is the credit application, invoices, and statements which lay down the rules of notice and rejection. Try the following in all documents: "Notice of any damaged, defective, and non-conforming products must be forwarded within 15 days from date of delivery to the sales manager only in writing specifying the claim thereof and identifying the products in question. Other forms of notice, oral, or to any other person are deemed ineffective. Failure to provide notice herein waives any claims. Hold all products in storage pending inspection and return material authorization, if allowed."

This statement sets the rules of notice and rejection. Most courts enforce this language, if reasonably conspicuous, fair in time and terms, and reasonable in practice. If the goods are food products, and terms are printed in bold print, the court will probably uphold this clause because customers usually discover any defects within a few days by smell, touch, or sight. If the goods are high-tech computer equipment, the period in these cases borders on the vaguely unreasonable because the customer might need a month before either testing the product or evaluating its quality.

The second line of defense is even simpler. Inscribe either a waiver of any warranties or offer replacement as the sole option for defective products. Typical waivers are "GOODS SOLD AS IS AND WHERE IS. ALL WARRANTIES ARE WAIVED, INCLUDING MERCHANTABILITY." Try this: "THE SOLE OBLIGATION FOR DEFECTIVE PRODUCT IS REPAIR OR REPLACEMENT." Elaborate in legal scope, this topic is left to the lawyers. If you have a

valid waiver clause, skip the rest of this article and go to the end. If not, continue. Take the next step. The customer writes the letter and complains that the product is defective. If the company disagrees with the customer's position, the next step is to demand a letter from the customer which details the claims of defects. This letter says, "give us a full and final written statement of all defects." This demand will roll into a letter, written by the customer, a complete list. Some courts have held that this will limit the customer's complaints to the list. Don't fail to make this demand.

What about the product itself? The customer must reject the product, which is a fancy term for holding products pending pick up and return, or other handling. The rule is simple for any customer sitting on bad products. If you don't want it, don't touch it.

What's the customer's duty for rejected products? If perishable, and assuming good notice and actual rejection, the customer can sell the products for salvage. If nonperishable, the customer can store at the seller's expense, reship the product, or even resell the product at the seller's expense and account.

Still worried about the customer with product claims?

The next line of defense is the telephone call. Spending a good part of the day on the telephone, you'll grill the customer with the following salutation, "Anything wrong with the product. No? Let's chat about the bill." Admissible in court, the statement and its likely response of "Huh. I don't have the money" is proof that the product was good, or that the customer did not provide the notice or missed the morning cup of coffee. Further, if the customer whines in court that the product was bad, these collection calls impeach the customer's personal veracity, which is a fancy way of calling the customer a liar.

Payment letters serve as platform to smoke out bad product claims. Start each letter with the following: "Finding nothing wrong with the product, the bill, or the amount, you agree to pay us $__, in monthly installments. If default, the total is due—interest runs at 18 percent. Sign here. If a guarantor, sign here, too."

If the customers tell you, "Yes, the product was a dog," and winds through a long litany of claims, don't worry. This is the time for the deal. The customer really has two problems: Bad product and no money. Let's merge the two. Say the following, "I don't really know if the product was bad. I don't have any record of these claims and our invoice requires written notice. This bill is also very overdue. We'll trade. I'll drop you a note through the fax (we all have faxes, don't we) which says, "resolving your claim of bad product, and your bill to our company, we agree that you will pay us $__, down, $__ per month, till paid. If default, the total is due. Interest accrues at 18 percent per annum, until paid. Please sign here. If a guarantor, sign here, too. This is a settlement of our bill and your claims of bad product, which you release and waive." Although not perfectly lawyer proof, nor fool proof, this deal will solve about 90 percent of most defective product claims.

Are your customers a little slow in signing their names? Try the confirming letter, "Finding nothing wrong in the product, our bill, or the amount you owe us, pay." Short, simple, and direct.

Like face to face meetings with customers who are very reluctant to sign an agreement? Try this, "o.k., we'll take your deal of payment over the next millennium. Please sign or initial the invoice or statement with the words, 'o.k. to pay.'"

Don't like this process? Any lawyer will tell you to put your agreements to writing. The barrier is getting the person to sign the writing. Hesitant to sign any "legal looking documents," customers will sign a document which is familiar, even an invoice or statement. Something is better than nothing, and invoices "okayed" by the customer are written evidence of approval.

Still getting nowhere with the customer? The customer complains about the product. Tell the customer: "I'm not sure if you are right or wrong. Don't sell the stuff, store it, and we'll send someone down there." If the customer responds by stating that the product is gone, stolen, sold, or trashed, tell the customer, "No, no, no. If you don't like the product, reject it, ship it back, or hold it for us. You can't have your cake and eat it too." Write the following, "Finding no problem with our product, you sold it. Pay us."

Solved the problem? Most products leave your shop in good condition, and defective product claims are rare, but very ugly. Your remedy out of this mess is pushing the debtor to either notify you of the claim (cut bait) or waive the claim (fish).

Personal Guarantees

Sally, the credit manager, barges into her boss' office. "I have good news and bad news," she says. Her boss replies, "Ok, spill the beans."

"You remember, FOODCO, our biggest customer."

"Yes, I do."

"You remember. They are always slow pay."

"Well, Yes, I do. Sales always has to call."

"Well you don't have to worry about FOODCO slow paying any more."

'Why is that, or should I ask? ."

"The good news is that they filed bankruptcy."

"What's the bad news?"

"The owner didn't sign the personal guaranty."

Ever have this conversation? No? Let's start the guaranty tour . . .

What is a personal guaranty? This is a written promise by another person to pay a wholesaler's bill.

Must the personal guaranty be in writing? Yes, any exceptions are very remote.

The owner of the customer says, "Don't worry, I'm good for my company's bills, You don't need it in writing. Isn't this enough?" Not for a personal guaranty. A wholesaler might use this language in a fraud or alter-ego suit. Anyway, the owner will deny that he or she ever said this.

What is the magic language? Guaranties appear in a thousand different varieties. The basic words are: "I guaranty payment of my company's bills." The guarantor must sign his or her name.

How about a personal guaranty on the credit application? Appearing at the bottom of the credit application, these guaranties require the signature of the guarantor.

Must the guarantor be an owner of the company? No. Anybody can guaranty the account, but owners are the norm.

Will the guaranty assure payment? No. The guaranty only gives you another person who is legally liable to pay your bills, besides the customer. You can sue two, not just one, person for the bill.

Can the guarantor file bankruptcy? Yes. In most small businesses, when the corporate customer fails, its corporate principal, who issued you a personal guaranty, may

also fail.

How about a faxed guaranty? Untested. A wholesaler takes a big chance with a fax guaranty. Obtain the original at all costs.

If I go to court, will the guarantor claim a forgery? Yes, whenever possible. Try and have the salesperson personally witness the signature. Notarized signatures are good substitutes. Confirm guaranties with letters and telephone calls.

Can I insert a personal guaranty into the body of the credit agreement? The following words, "The officers of this company personally guaranty payment of the company's bill" are very common language. The answer is that the officer who actually signed the credit application might be liable, but the other officers are not. Most judges dislike these single signature credit applications and personal guarantees. Ambiguities in drafting obliterate guaranties.

Do I need the wife (or the spouse) to sign a personal guaranty? Yes. Husbands and wives are not necessarily liable for each other's business debts. As exceptions, husbands and wives are jointly liable as partners, or jointly contracting, or the bill was for a necessity. Consumer cases have different rules. When faced with the other spouse's debt, a spouse will claim that the business was separate property or assert a prenuptial agreement.

But I thought husbands and wives are legally partners in the business. This is not necessarily correct. Marital status is not partnership status. Get both signatures of the credit application or personal guaranty.

I thought partners are liable for the bills of the partnership. Why do I need their signature on the credit application and personal guaranty? First, a wholesaler is only assuming partnership status. When faced with liabilities of $100,000.00, the silent partners deny any association, claim that the partnership credit applications, liquor license or even State Tax Permit is erroneous, or limited partnership status.

Well, at least, the general partner of limited partnership is liable for a limited partner's bills? Right? Yes, this is correct, but sometimes the general partner is a corporation with limited assets.

If the business sells, will the guaranty protect me for purchases by the new owners? Yes and no. If the guarantee is unrevoked, and the account is the same, you might have some luck in affixing the new bills on the old guarantor. This is a very treacherous area of the law, and the law will favor the guarantor. Good credit judgment dictates starting over with the new account.

Can the owner absolve himself or the guaranty for future bills? Yes, this is called revocation, which is usually done in writing. Once revoked, you have no guaranty for future purchases. Make sure all notices of revocation come to the credit manager, not sales and are forwarded registered mail.

How about payment programs, changes in credit terms, interest rates, prices, or a work out? If the customer fails, can a wholesaler still sue the guarantor? This question enters the area of exoneration, which is a fancy word for destroying the guaranty. Any alteration to the underlying credit relationship, such as a change in terms, price, payment, due dates, may discharge (or release) the guarantor. Good forms of guaranties prevent this disaster. If you change the terms, always have the guarantor consent in writing.

If the customer is bankrupt, can I sue the guarantor? Doesn't the bankruptcy stop the suit? Yes, you may sue the guarantor, and the bankruptcy is irrelevant. Remember to file the claim in the proceeding.

I didn't get the personal guaranty signed on the credit application. Is all hope lost? No. If the customer defaults on the account and wants a payment program, demand a personal guaranty on the payment program with such language, signed separately by the guaranty as "I personally guaranty my company's obligations under this PAYMENT PROGRAM." Require a signature.

The customer tendered a corporate check, which I suspect is n.s.f. What can I do, besides rejecting the check, which might clear anyway, and demand a cashier's check? Demand that the corporate principal, who is usually the sole shareholder, officer and manager, personally endorse the check. An endorsement has the same legal effect of a personal guaranty.

I am offered a long term payment program or a cash compromise from the customers. The offer is terrible, and the customer is close to bankruptcy. I have no guaranty, and if the customer files bankruptcy, I may have to return all of the payments as bankruptcy preferences. Now what? First, timing is essential to any bankruptcy preference, which requires repayment of monies received within 90 days of filing. Delay the filing and beat the preference. As part of the deal, demand that the corporate owner indemnify against any preference liability with the following: I will personally indemnify and hold you harmless of any preference liability in any bankruptcy filed by my company."

Beating the Preference

For the uninitiated, a preference is the right of a bankrupt entity (debtor or trustee) to get back (recover) monies paid by an insolvent debtor (customer) on a past-due bill within 90 days of the bankruptcy filing. A preference means that monies collected through normal debt collection is returned to the bankruptcy estate.

Most preference discussions are boring. However, in the spirit of the impossible quest, we will tackle the basics. If a wholesaler receives a demand letter for a preference, must the money be returned?

Presuming preference liability, the wholesaler is not legally obligated to return the money based upon the letter. At worst, if the money is not returned upon demand, the only additional liability is interest and costs. In any event, always consult an attorney.

How should a wholesaler respond to a letter demanding a return of money, claimed a preference? The answer is threefold. Some wholesalers correspond in return and provide information; the advantage is the letter might dispel the entire problem; the disadvantage is that the responsive letter will spur the trustee or debtor to continue collection efforts and keep the file alive on somebody's desk. Others advise to ignore the letter; maybe the whole matter will be forgotten, which happens from time to time; the disadvantage is that the debtor or trustee, along with the court, in the face of silence may believe that the wholesaler is hiding something. Others might advise to string the entire matter out, providing as little information as possible and at the end settle the claim. Ask as many experts in this area, and you'll get as many opinions.

How does a wholesaler know they have been sued? In most cases, the trustee or debtors will mail the lawsuit to the wholesaler which is valid service of process.

If sued, what are the basic defenses? This topic consumes volumes of legal materials. However, the shortest statements of the basic defenses follow.

1. The payments were in the ordinary course of business of both payor (debtor) and recipient (wholesaler). The fact that

the customer paid a bill late is not fatal to the defense on the basis that some customers habitually pay all bills late, and some wholesalers regularly accept late payments.

2. **The payments are for C.O.D. purchases or payment within terms.** Most preference claims erroneously include C.O.D. payments.

3. **Statute of limitations, which is two years.** This topic is complex in accounting for Chapter 11's, converted Chapter 7's, successor trustees etc.

4. **Post payment credit.** After receiving payment on an old bill, the wholesaler will extend additional credit, which sours. This new debt offsets any preference liability.

5. **The debtor is solvent.** (Don't hold your breath.) Bankruptcy does have a purpose. These are the most common defenses, and court cases are chalk full of other, more imaginative, defenses.

Are preference cases settled? Yes, and the average seems to range between 25 and 75 percent. If stuck with a preference, consider settlement starting in the 25 percent range.

How can a wholesaler settle a preference? Besides paying money, some wholesalers have given the debtor (or the trustee) product in return. This raises a larger issue. If the wholesaler received a product return as the claimed preference, the wholesaler could offer settlement by a return of the same or similar product or its cash value.

Can a wholesaler get any money back? Yes, file a claim with the estate but expect pennies on the dollar.

Should/ can a wholesaler worry about preferences? Yes and no. Faced with a debt collection call, the debtor would say, "I'll pay you, but we'll get the money returned because I am going to file bankruptcy in 90 days." The answer is don't worry. First, the debtor hasn't filed bankruptcy yet. Second, many preferences are lost or forgotten in the shuffle of many bankruptcy filings. Third, a wholesaler is not legally obligated to return the money, unless the judge orders it. Finally, the debtor has to file bankruptcy in 90 days from the payment. The 90-day-time period is the most important consideration. A preference means payment of an old bill within the 90-day period.

How can a wholesaler delay a bankruptcy filing at least until the time for a preference to run? Rewrite the credit application and personal guaranty to add the following words: "The owners shall indemnify and hold harmless WHOLESALER of any loss or liability, damage, claim, award or judgment based upon any claim of PREFERENCE under 11 U.S.C. 547(b) or state law brought by this credit applicant, its successors or affiliates, trustee in bankruptcy, or other entity and shall pay along with any attorneys' fees incurred in the defense thereof, all amounts claimed as a PREFERENCE, or settlement thereof."

This language is really too long. Try the following: "The owners of this credit applicant shall personally reimburse wholesaler for any claimed bankruptcy or state law preference." The threat of supposed personal liability may delay the filing date, rendering the payment on account non-preferential. Timing is everything.

In the midst of any commercial collection call, the debtor will claim that payment of the old bill is useless because the debtor intends to file bankruptcy and the monies will come back. This magic language will permit the wholesaler to responsively state, that any preference claim will be met with a personal suit for reimbursement, or more succinctly, "Delay your filing and personally save yourself the grief of suit against you."

This language, although somewhat untested, is helpful in a corporate or partnership bankruptcy setting. This will not help in a sole proprietorship setting and is somewhat worthless if the owners of the company file personal bankruptcy, although the wholesaler will receive a second dividend from the owner's estate.

Calculating the New Value Defense: How To Avoid Being Shortchanged

By Bruce S. Nathan
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An unsecured trade creditor whose customer files a bankruptcy petition faces a double-edged risk. First, there is the risk of nonpayment of the creditor's claim. Second, there is the risk that the creditor may be compelled to return all preferential payments received within the applicable period (usually 90 days) prior to the debtor's bankruptcy filing. These recoveries become part of the bankruptcy estate that is ultimately distributed to creditors in order of the priority of their claims. General unsecured creditors who are nearly at the bottom of the priority ladder recover what is left after more senior creditors are paid in full.

We now enter what one Circuit Court of Appeals humorously refers to as "the Preference Zone". According to Section 547(b) of the Bankruptcy Code, a trustee or debtor could recover a payment as a preference by showing that the payment was: a transfer of the debtor's assets; made for the benefit of the creditor on account of outstanding indebtedness owing by the debtor to the creditor; made within 90 days of the debtor's bankruptcy filing (or one year for payment to or for the benefit of an insider); made when the debtor was insolvent; and which enabled the creditor to receive more than it would have received in a Chapter 7 liquidation.

Congress provided for this preference avoidance power to ensure an equitable distribution of the debtor's assets among all of the debtor's creditors and to discourage creditors from racing to the courthouse to recover on their claims ahead of other creditors, and thereby precipitate the debtor's bankruptcy filing.

However, not every payment of existing indebtedness during the preference period is recoverable as a preference. Trade creditors should take heart (and bankruptcy trustees and debtors grumble) from the fact that the Bankruptcy Code affords creditors several defenses to preference claims. Among these defenses is the new value defense of Section 547(c)(4). For trade creditors, the new value exception applies where the creditor sold goods or rendered services on credit to the debtor and the debtor made a series of payments to the creditor during the preference period. To the extent that the creditor extended new value to the debtor by shipping goods or providing services on open account following any payment, such new value reduces the preference claim.

There are two policy reasons for the new value defense. First, creditors that have enhanced the debtor's estate by providing new goods and/or services on credit, after receiving a payment from the debtor, should not be penalized. Creditors who continue to extend credit to their customers after receiving payment of existing indebtedness, without an offset for new credit extended following the payment, face the risk of substantial additional losses as a result of their customer's bankruptcy filing. Second, the new value defense encourages

creditors to continue extending credit to their customers and thereby reduces the risk of the debtor's bankruptcy.

There are two ways of calculating new value. Which method a trustee or debtor uses will have a direct bearing on the amount of new value available to reduce a preference claim.

A majority of courts have adopted the more generous method of calculating new value. A trade creditor could offset new credit against the immediately preceding preference payment and all prior preference payments. Utilizing this method, trade creditors can carry preferences forward until they are fully offset by subsequent new credit. This method of calculating new value recognizes that lines of credit generally involve a series of payments and extensions of credit.

A minority of courts have adopted the more limited anti-creditor approach to calculating new value. A trade creditor is protected only to the extent that it extended credit between preference payments. This approach divides the 90 day preference period into a series of isolated transactions in which new credit that the creditor extends is netted only against the immediately preceding preference payment.

The different results achieved from these methods of calculating new value are best shown in the following sequence of payments and extensions of credit during the preference period: The gross preference claim before considering the new value extensions of credit is $12,000.

If a court applies the majority more liberal pro-creditor approach to calculating new value, there should be sufficient new value to reduce the preference claim to zero. Of the $10,000 in new credit extended on 6/16, $5,000 would be applied to the 6/15 preference payment of $5,000 and the remaining $5,000 would be applied to what remains of the 6/6 preference payment of $3,000, after deducting new credit of $1,000 extended on 6/8, and then to the 6/1 preference payment of $4,000, after deducting new credit of $1,000 extended on 6/3.

If a court applies the minority more limited anti-creditor approach to calculating new value, the net preference claim totals $5,000. By limiting the new value defense to only extensions of credit between each preference payment, the creditor could deduct the following from the gross preference claim of $12,000: the $1,000 extension of credit on 6/3 from the $4,000 payment on 6/1; the $1,000 extension of credit on 6/8 from the $3,000 payment on 6/6; and $5,000 of the $10,000 extension of credit on 6/16 to the $5,000 payment on 6/15. This method of calculation precludes the creditor from offsetting the remaining $5,000 of new credit extended on 6/16 from the 6/1 and 6/6 payments.

The majority view is the more appropriate method of calculating new value. There is nothing in Section 547(c)(4) that limits the new value defense to extensions of credit between preference payments. In fact, the courts applying the minority view do not offer any explanation for their more limited approach to calculating new value. The majority view also encourages the extension of credit to financially troubled companies and reflects a more realistic view of commercial practice.

However, trustees and debtors are still free to calculate new value based upon the more restricted minority approach. This may shortchange creditors in the amount of new value that could be offset against a preference claim. Trade creditors who are the targets of preference claims should review the trustee's or debtor's calculation of new value to determine whether it is based on the more limited minority approach to calculating new credit. If that method is being used, creditors should be prepared to do their own new value analysis based upon the majority view that considers all extensions of credit after the preference payments. This may significantly reduce (or eliminate) the preference claim and avoid the necessity of relying on other preference defenses that may be more difficult and expensive to prove.

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Reclaiming Seller Versus Inventory Holder: Who's on First

By Bruce S. Nathan

As a general rule, a trade creditor of an insolvent buyer has an unsecured claim in the buyer's bankruptcy case. As such, the creditor is entitled to share in the distribution of the assets of the buyer's bankruptcy estate after payment of more senior priority claims. Translation: The creditor will usually realize only a fraction of its unsecured claim (if even that much) after a long delay.

However, as to all goods that a trade creditor delivered to the buyer shortly before the buyer's bankruptcy, the creditor may have a right of reclamation arising under Section 2-702 of the Uniform Commercial Code (UCC) and Section 546(c) of the Bankruptcy Code. A trade creditor seeking reclamation of its goods must satisfy the following requirements:

1. For a buyer filing a bankruptcy petition before October 22, 1994 (the effective date of the 1994 amendments to the Bankruptcy Code), the creditor must send a written reclamation demand to the buyer before ten days after the buyer's receipt of the goods. For a buyer filing a bankruptcy petition after October 22, 1994, the creditor must send a written reclamation demand to the buyer either before ten days after the buyer's receipt of the goods or if the buyer received the goods within ten days of the filing of the bankruptcy petition, before twenty days after the buyer's receipt of such goods.

2. The trade creditor must have sold the goods to the buyer on credit and in the ordinary course of the creditor's business.

3. The buyer must have been insolvent when it received the goods.

4. The buyer must have possession of the goods when it received the reclamation demand.

A trade creditor who satisfies all of these requirements and aggressively pursues its reclamation rights has a far greater likelihood of recovery on this claim. The creditor may receive payment for the goods, get the goods back, be granted a security interest in other assets of the buyer, or be granted a priority administration claim in the buyer's bankruptcy case that would be payable ahead of all unsecured claims.

However, a trade creditor may lose its enhanced right of recovery on its reclamation claim if all of the buyer's inventory is subject to a prior perfected security interest. That is because Section 2-702(3) of the UCC subjects the creditor's right of reclamation to "the rights of a buyer in the ordinary course or other good faith purchaser." Since a good faith purchaser includes a creditor with a perfected security interest in inventory, a secured creditor's interest in