

MANAGING THE MELTDOWN: SURVIVING YOUR CUSTOMER'S FINANCIAL DISTRESS

Presented to:



Pentair

WEAPONS FOR THE PROACTIVE CREDIT PROFESSIONAL

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February 14, 2005

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INTRODUCTION

BASIC PREMISE APPLICABLE TO UNSECURED CREDITORS IN BANKRUPTCY

unsecured creditors + bankruptcy =



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Why This Stuff Is Important

- Collection when your customer is distressed: Survival of the Fittest
- Easy solutions--become secured, third party guaranty, don't sell--no sales = lose your job
- Diligence alone will not cut it
 - Preferences
- The Judicial System (except for lawyers) is not what its cracked up to be.

PROGRAM OVERVIEW

- I. Collection Strategies For Financially Distressed Customers
- II. Drafting Contracts for the Supply of Goods to Financially Distressed Customers
- III. Getting a Leg Up: Notes, Guaranties, Security Interests and L of Cs
- IV. Seller's Rights to Return of Goods
- V. Bankruptcy: Commencing and Surviving the War

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Collection Strategies for Financially Distressed Customers

TOPICS DISCUSSED

- Acquiring Information
- Sue or Settle
- Themes in Decision Making Analysis
- Negotiating and Drafting Settlements
- Pre-Judgment Remedies
- Post-Judgment Collection

Acquiring Information

Information Gathering becomes even more critical

- Normal: Financial Statements, UCC's, D&Bs, credit group information
- Troubled Times: Must Dig Deeper – Remember not only a two-party dispute, possibly you against all other creditors

? Warning Signs ?

- ? a) Change in Corporate Structure**
- b) Dividends/repay loans to insiders**
- c) Inter-company loans/payments**
- d) Other suppliers obtaining guaranties**
- e) Change of product lines**
- ? f) Efforts to raise capital (bonds, foreign S-1, bank debt with warrants, etc.)**
- ? g) Switching Banks**
- h) Existing Bank obtains additional collateral**
- i) Collection Amounts**
- j) Purchasing goods outside ordinary channels**
- k) Extending payments**
- l) c/s unit sole volume decreases**
- ? Don't forget salesman/local reps as information source**

Collection Lawsuits: Sue or Settle?

“Begin with end in Mind”

Sue the Bastard

Settle: Cut losses



INFORMATION

- | | |
|--|--|
| A. Few lawsuits pending against customer | A. Multiple pending collection lawsuits |
| B. Bank's security interest is limited, or only PMSI | B. All assets are pledged to the Bank |
| C. No affiliated/related company transactions | C. Corporate shell game |
| D. Financially strong | D. Red ink piling up – or will not provide financials |
| E. Principals financially strong | E. Principals financially weak or numerous personal guaranties |
| F. No counter claims or affirmative defenses | F. Counter claims and affirmative defenses |
| G. Hate the guy | G. Like the guy |

Others

Sue or Settle?

Financially distressed customers potentially turns two-party battle (Supplier/Creditor v. Customer/Debtor) into war: one supplier against 100's of vendors

Themes In Decision Making Analysis

- Legal Costs: Return on investment in litigation
- Integrity of debtor's management
- Future considerations:
 - Business prospects
 - Customer/strategic: geographical, size, etc.
- Consider big picture in addition to merits of the particular lawsuit
- Potential for Counterclaims

Negotiating and Drafting Settlements

- Acquire financial information; make it part of settlement
- Goal – Amount of recovery is key, but only half the equation
- Don't cause bankruptcy
- Preferential transfer protection
- Expand the “Hook”
 - a) solvency representation/affidavits
 - b) third party guaranties
 - c) preferential transfer indemnity
 - d) collateral
 - e) letter of credit
 - f) others
- Don't extinguish the entire debt until paid in full
- Don't re-try case: agreed judgment – even if not filed immediately

Pre-Judgment Remedies

GOAL: Begin with the end in mind – seize assets prior to completing collection lawsuit

EXAMPLES: Attachment, garnishment, sequestration, receivership, and injunction
- Unsecured Supplier ➤ Attachment

BE READY: Must move quickly and must post bond

Attachment

- Is attachment available to you?
 - (a) Defendant/customer justly indebted to you? AND
 - (b) Not sought for harassment? AND
 - (c) Without attachment, creditor will not collect debt?
 - (d) Then also need at least one of the specific grounds:

Specific Grounds For Attachment

Defendant/Customer:

- Is not resident of state
- Is about to move from state and has refused to pay or secure debt
- Has hidden or is about to hide his property for the purpose of defrauding creditors
- Is about to remove property from the state without leaving an amount sufficient to pay debts
- Is about to or has disposed of all or a substantial portion of assets with an interest to defraud creditors
- Is about to convert all or a substantial part of his property into money for the purpose of placing it beyond the reach of creditors
- Owes debt for property obtained under false pretenses

- Attachment varies slightly from state to state
- Examples
 - (a) 12 year-old Scotch example
 - (b) What a Law Firm does

Post-Judgment Collection

- Judgment equivalent to an undisputed invoice as far as bankruptcy is concerned.
- Judgment without immediate collection strategy = Hollow Victory

Post-Judgment Collection

- Judgment = undisputed invoice
- Judgment lien creditor > judgment creditor
 - a) How to perfect judgment lien
 - B) Real property
 - C) Personal property
- Appellate Process
 - a) Motion for new trial
 - b) Bond
 - c) Appeal
- Post-Judgment Collection
 - a) Interrogatories
 - b) Deposition (take a break and garnish)
 - c) Garnishment
 - d) Levy and execute
- Fraudulent Conveyance Possibilities

Managing the Meltdown

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Drafting Contracts for Supply of Goods to Financially Distressed Customers

TOPICS DISCUSSED

- Executory Contracts
- Consignments
- Bailments

Drafting Contracts for Supply of Goods in Anticipation of Bankruptcy

- Executory contracts in bankruptcy
 - a) Material performance remains on both sides
 - b) Consequence: Cure entire prepetition default AND adequate assurance of future performance
 - c) Example
 1. Supply/requirements contract
 2. Advertising, promotion, additional services by supplier
 - d) General Rule: free country -- you do not have to sell in bankruptcy -- not even on COD terms
 - e) Beware: if executory contract could require you to supply in Bankruptcy

- Consignments
 - a) Put your goods in the customer's location
 - b) UCC-1 is critical
 - c) Favorable bankruptcy treatment
- Sell to parent or other healthy affiliate
- Set up bailment arrangement
 - a) Sell to third party
 - b) Customer only orders to fill orders
 - c) Reduces customer's cost of carrying inventory and supplier's outstanding balance
 - d) Goods in bailment not subject to c/s' bank liens

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Getting a Leg Up:

TOPIC DISCUSSED

- Promissory Notes
- Guaranties
- Security Interests (Including PMSIs)
- Letters of Credit

Promissory Note

A promissory note is desirable because it may be more easily and cost-effectively enforced in court in comparison to other types of contracts.

- Negotiable Instrument
- Not subject to open account defenses: defective goods, rebates, return offsets, coop/promo credits, etc.
- More easily transferred

Be aware of usury issues.

- Usury laws vary from state to state
- Usury laws vary according to the parties and circumstances involved

Guaranty

A guaranty is a written promise by an individual or other entity to repay the customer's indebtedness. It is an independent source of repayment of the customer's indebtedness.

A guaranty may itself be secured by security interests and/or liens (mortgages).

May protect against bankruptcy and preferential transfers.

“Encourages” customer to pay debts subject to guaranty ahead of other vendors.

Getting a Leg Up: Security Interest/Liens

Objective: Convert unsecured debt into secured debt

Obtain a security interest in customer's property

Security Interest: customer grants an interest in its personal property to supplier to secure payment of an obligation.

Accomplished by a security agreement between supplier and customer and filing a UCC-1 financing statement

Security agreement may secure repayment of account indebtedness itself or account indebtedness may be documented in a promissory note. If so, security agreement may secure repayment of promissory note.

- New consideration (promises) exchanged by debtor and supplier
- Customer's property now secures repayment
- “New” promise by supplier often consists of extended repayment date, brief forbearance of collection of past due debt, willingness to extend terms again, etc

Security Interests: Personal v. Real Property

- Personal Property: Obtain Security Agreement and UCC-1 financing statement. Perform a UC lien search to determine which other creditors may claim a security interest in customer's personal property. Determine significance of Security Interest.
- Real Property: Deed of Trust or Mortgage, filed in county real property records

Enforcement: Self Help v. Judicial

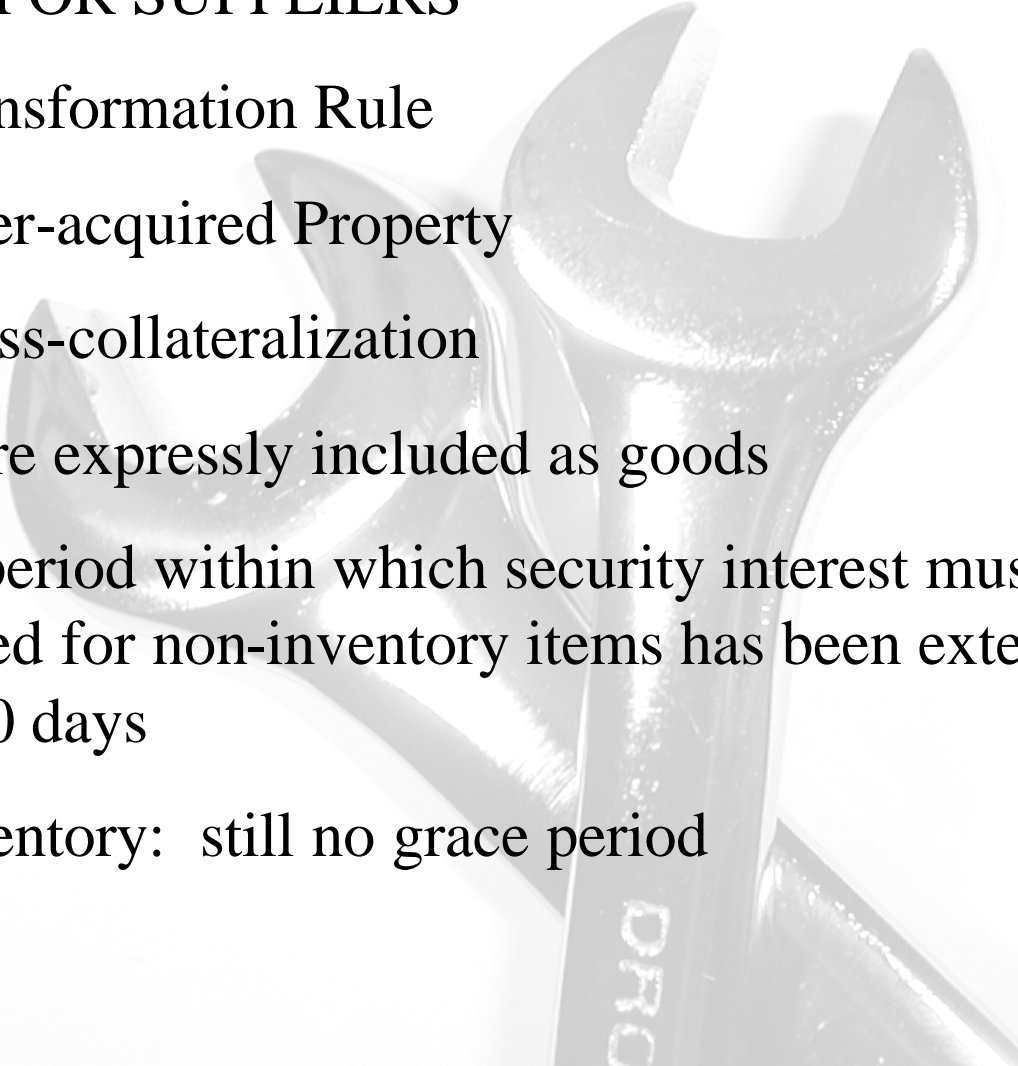
The security agreement and the deed of trust (mortgage) may be enforced by non-judicial foreclosure. This is a much cheaper and faster alternative than judicial foreclosure (lawsuit).

Even in situations where non-judicial enforcement is not available, the promissory note and guaranty are straightforward contracts that may be enforced cost-effectively even though a lawsuit is involved.

1. Demand Letter: Default and opportunity for cure
2. Demand Letter: Enforce rights under Security Agreement and UCC
 - a) take possession of Collateral
 - b) assemble Collateral
 - c) can't breach the peace – Judicial Foreclosure Sale
3. Lien search: other parties with security
4. Notice of Foreclosure Sale
 - a) Customer
 - b) Other secured parties
 - c) “Commercially Reasonable” advertising
5. Conduct Sale
6. Enforce Deficiency
7. Compare Real Property

Purchase-Money Security Interest

- Allows supplier to obtain a lien with priority over bank's security interest in the supplier's inventory
- UCC 9.103 a security interest is a “purchase-money security interest” to the extent that it:
 - (a) granted in the specific goods supplied by PMSI holder; and
 - (b) the PMSI secures the extension of credit used to acquire the inventory
- Rationale: provides “enabling” funds; bank is no worse off

- 1) Transformation Rule Eradicated: PMSI MUCH GREATER TOOL FOR SUPPLIERS
 - Transformation Rule
 - After-acquired Property
 - Cross-collateralization
 - 2) Software expressly included as goods
 - 3) Grace period within which security interest must be perfected for non-inventory items has been extended from 10 to 20 days
 - Inventory: still no grace period
- 

- How to obtain a PMSI
 - (a) determine in which state the debtor is located
 - (b) conduct a UCC search
 - (c) give written notification to existing secured creditors
 - (d) obtain signed security agreement from customer
 - (e) file UCC-1 in proper state before delivery of goods
 - (f) conduct a follow-up UCC-1 search
 - (g) tickle calendar for 5 years to file a continuation financing statement

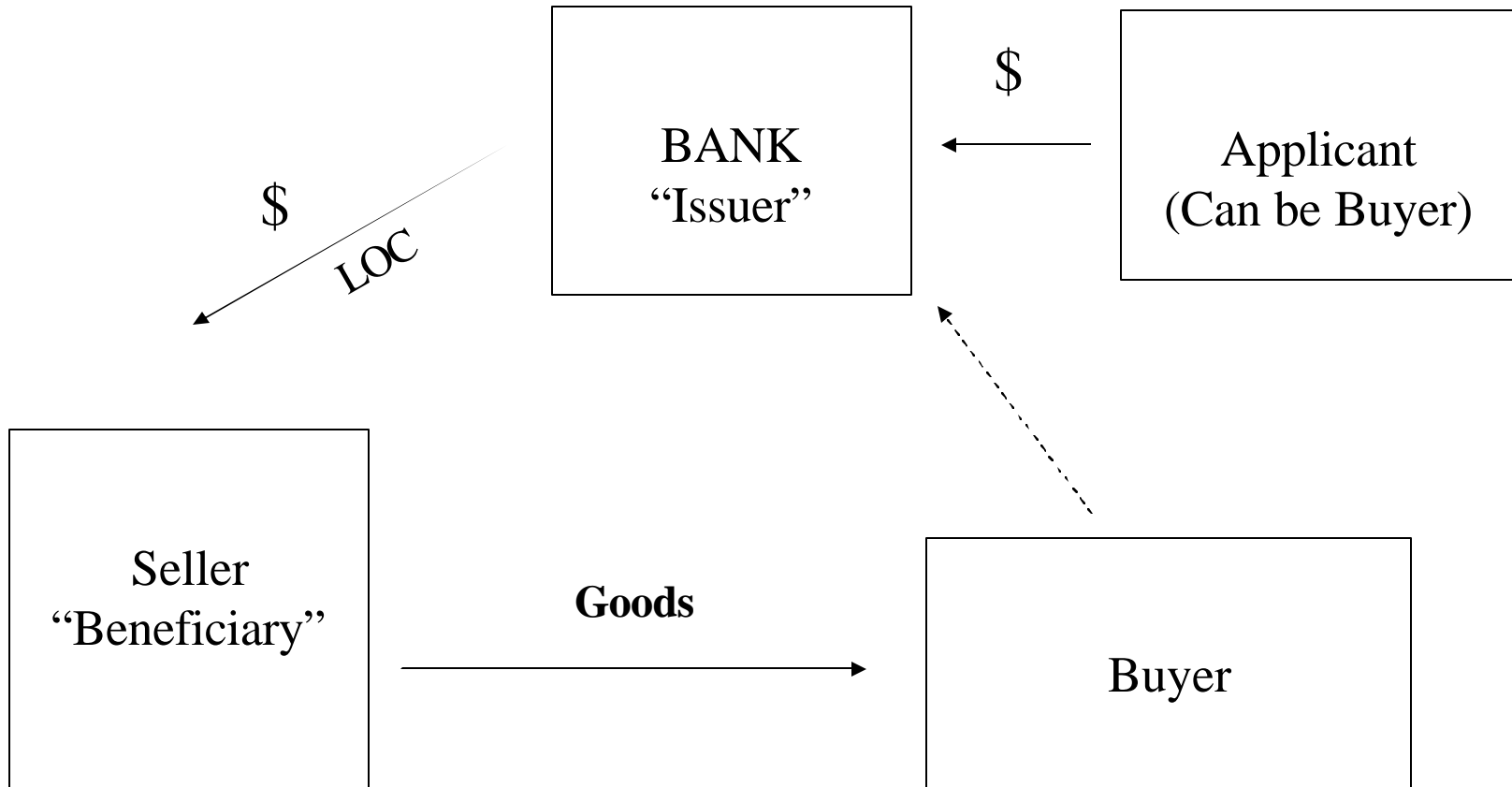
BE AWARE:

- Refile continuation statements every 5 years
 - a) Re-notice secured parties
- Floating lien problem
 - No Accounts Receivable
 - “Identifiable Cash Proceeds”
- Don’t forget follow-up UCC-1 search

Letter of Credit

An independent obligation of a bank or other financial institution to pay you for goods sold.

Relationships involved in letter of credit transaction



Commercial Letter of Credit

- Provides payment to seller upon presentation of documents to bank, generally showing that buyer received goods

Standby Letter of Credit

- Provides payment to seller upon seller's statement to the bank that the buyer breached its obligation to pay.

Letters of Credit

Advantageous in Bankruptcy situations

Watch out for:

1. Expiration date
2. Specific instructions to be paid
3. Letter of Credit v. Security Interests
 - Agreement to Provide
 - Enforcement

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Seller's Right to Return of Goods

TOPICS DISCUSSED

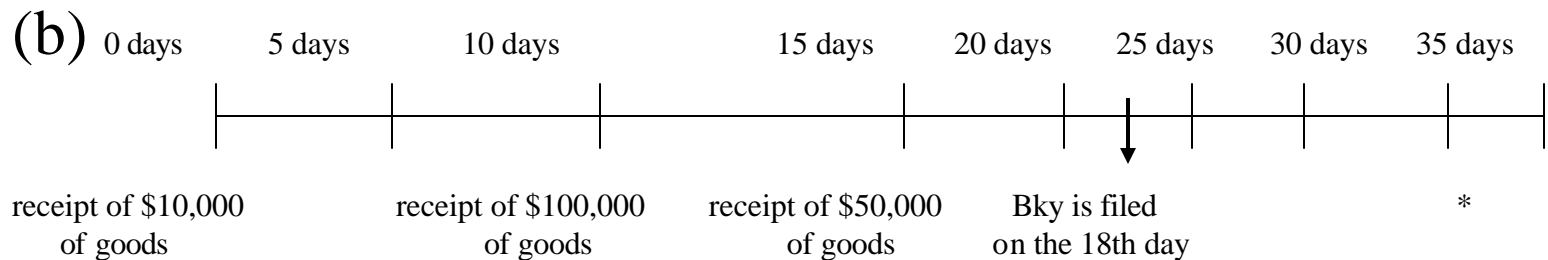
- Reclamation
- Stop Goods in Transit

Reclamation

Reclamation provides unsecured suppliers with a relatively short window of opportunity to regain possession of goods despite not possessing a security interest in inventory

- Applicable to goods received within 10 days of customer's receipt (some jurisdictions 20 days)
- Written misrepresentation of solvency extends time period to reclaim
- Subject to ordinary course buyers and secured lenders

- Outside of bankruptcy
 - (a) upon learning that a customer who has recently received goods is insolvent
 - (b) make a written demand within ten (10) days from the time the customer receives the goods
- After bankruptcy - upon learning of the bankruptcy filing
 - (a) make a written demand within ten (10) days after the Debtor's receipt of goods or if such ten (10) day period expires after the bankruptcy filing, then make written demand before twenty (20) days after the receipt of goods



(c) Remedies:

- (i) Possession of “Reclaimed” merchandise;
- (ii) A lien; and
- (iii) Administrative Claim.

(d) Subject to: (i) Bank's prior liens; and (ii) ordinary course of business sales

- (i) Under-secured Bank means Administrative Claim or lien worth zero
- (ii) Reclamation mandates immediate aggressive action in the Bankruptcy Case

Stopping Goods In Transit

- When a Seller discovers the Buyer's insolvency, the Seller may stop delivery of goods in possession of
 - a) a carrier
 - b) bailee (3rd party holding the goods, i.e. an independent warehouse)
- UCC 2-705 provides that a Seller may stop delivery until:
 - a) the Buyer receives the goods
 - b) any bailee of the goods, except a carrier, informs Buyer it holds the goods for the Buyers
 - c) a carrier makes such acknowledgment to the Buyer by reshipment or as warehouseman
 - d) any negotiable document of title concerning the goods is negotiated to the Buyer

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Bankruptcy: Commencing and Surviving the War

TOPICS TO BE DISCUSSED

1. Involuntary Bankruptcy
2. Preferential Transfers

Involuntary Bankruptcy

- Strategic reasons to file an Involuntary Bankruptcy
- How to commence an Involuntary Bankruptcy
- What happens after an Involuntary Bankruptcy Petition is filed?
- Bottom line to unsecured creditors

Strategic Reasons To File Involuntary Bankruptcy

- Debtor's only paying debts that the principal has guaranteed
- Removal of property or sales outside the ordinary course of business
- Bank control
- Insider transfers
- Debtor's selective payments
- Trapping preferences
- Control location of the bankruptcy case
- Incompetent management
- Debtor's intention to over-collateralize bank
- Judgment creditor is about to levy on unencumbered property

How to commence an Involuntary Bankruptcy

- Three or more creditors
- Aggregate debt of \$10,775
- Creditors cannot be subject to a bona fide dispute
- Sign a two page petition (Exhibit no. 5)
- Due Diligence before filing a petition is critical

Key To Victory

- Due diligence before filing involuntary petition is absolutely critical
- Once You File - you can't "unfile" or dismiss involuntary petition

Order of relief: Is the debtor generally paying its debts as they come due?

- (a) No exact definition
- (b) “regularly missing a significant number of payments which are significant in amount in relation to the size of the debtor’s payments”
- (c) Consider: (i) number of debts; (ii) amount and duration of delinquency; (iii) materiality of non-payment; and (iv) manner in which debtor is conducting its financial affairs
- (d) case by case; no one factor is determinative

3. What happens after an Involuntary Bankruptcy Petition is filed?

- Unlike a voluntary bankruptcy petition being filed, no order of relief is entered upon the petition being filed
- Life in the Gap
 - (a) automatic stay
 - (b) debtor may continue to use, acquire and dispose of property as if the involuntary had not been filed
 - except: (i) to the extent otherwise ordered by the court, (ii) § 549(violative of the Bankrupt Code or Court order)
 - (c) preference 90-day time period begins
 - (d) suppliers extending credit in the “Gap” receive priority

REAL LIFE EXAMPLES: THE GOOD, THE BAD, AND THE UGLY

Miami
(The Good)

v.

Los Angeles
(The Bad)

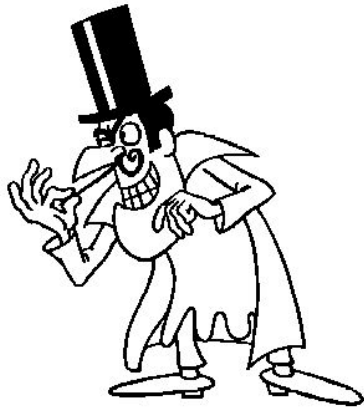
- Bad Faith Involuntary Bankruptcy Petition (The Ugly)
 - (a) objective test: would a reasonably prudent creditor have commenced an involuntary bankruptcy?
 - (b) subjective: specific creditor's motivations: motivated by spite, harassment, desire to embarrass as opposed to trying to get paid
 - (c) Damages include consequential and punitive
 - (d) two examples: Iowa; South Texas

4. Bottom line to unsecured creditors:

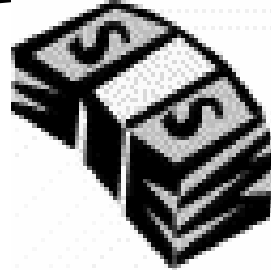
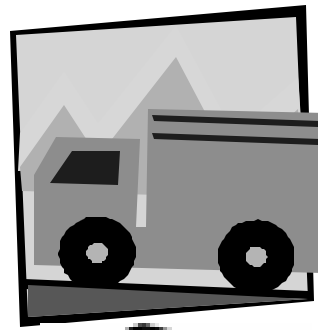
- DO DUE DILIGENCE -- involuntary bankruptcies are very hard to dismiss
- Consider what is to be gained, i.e. strategic reasons for filing
- Don't hesitate to use this very powerful weapon

Bankruptcy Preventing Preferences

Debtor



Creditor

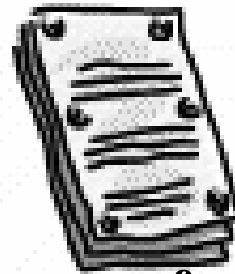


within
90 days

BANKRUPTCY



Trustee



preference
lawsuit



Creditor

Why Preferences?

1. Prevents debtor from selectively paying favored customers
2. Discourages creditors from putting debtor out of business
3. Encourages equality of distributions
4. Prevents secret liens
5. “Ideally” encourages creditors to continue dealing with debtor
6. Prevents debtors from paying insiders and related entities

Elements Of A Preference

1. Any transfer
2. Of an interest of the Debtor in property
 - payments
 - granting liens
 - executions on judgments
 - giving up options
 - anything that diminishes or depletes the debtor's estate
 - compare letter of credit

3. To or for the benefit of a creditor
4. For or on account of an antecedent debt owed by the debtor before such transfer was made
- i.e. for invoices that are due or past due
5. Made while the debtor was insolvent
“financial condition such that the sum of the debtor’s debts is greater than all of the debtor’s property, at a fair valuation”
6. Made within 90 days before bankruptcy is filed
(one year for insiders)

7. That enables such creditor to receive more than such creditor would receive if --
 - (A) the case were a case under Chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Preference Defenses

1. Contemporaneous Exchange (§ 547(c)(1))
2. Ordinary Course (§ 547(c)(2))
3. Enabling Loan Defense (§ 547(c)(3))
4. Transfer for Subsequent New Value (§ 547(c)(4))
5. Security Interests in Inventory or Receivable (§ 547(c)(5))

Ordinary Course of Business

- debt is in ordinary course of business of creditor and debtor
- payment is made in the ordinary course of business of creditor and debtor
- made according to ordinary business terms

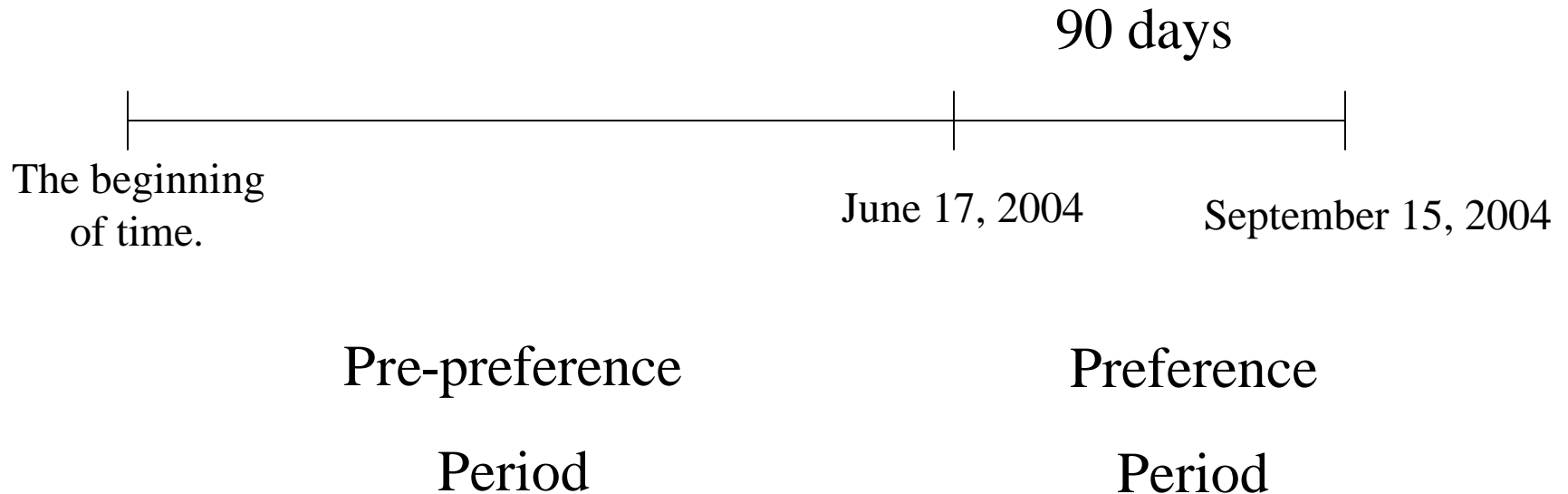
Enabling Loan Defense

- debtor gives security interest to creditor when creditor gives new value
 - at or after the security agreement describing property
 - to enable the debtor to acquire the property
 - used by the debtor in fact to get the property and
- creditor perfects it within 20 days after debtor receives property

Subsequent Unsecured Advances

- after alleged preferential transfer creditor gives
 - unsecured new value
 - the creditor does not receive payment (i.e. voidable lien)
 - what does “New Value” include?
 - goods shipped
 - liens released
 - new credit
 - new value does not include:
 - release of unsecured debt

DEBTOR FILES BANKRUPTCY ON SEPTEMBER 15, 2004



PREFERENCE DEFENSE QUESTIONNAIRE

To properly evaluate your company's defenses to the alleged preferential transfers at issue, it is essential that we understand the business relationship between your company and the bankrupt debtor. Accordingly, we ask that you provide us with a brief, but complete, written responses to the following questions:

1. How long has a business relationship existed between your company and the debtor?
2. On what credit terms did you do business with the debtor prior to the bankruptcy? (Beginning 15 months prior to the debtor's petition date and continuing to the petition date itself.) What grace period, if any, do you allow for payment? are special terms ever given for limited periods of time for promotional/seasonal reasons?

3. Are there seasonal factors associated with the products you sell, such that more product is sold (or paid for) depending on the time of year?
4. Are the credit terms on which your company does business with the debtor comparable to those you provided other similarly situated customers? Are your credit terms for this debtor comparable to those provided by your competitors?
5. Was there a change in credit terms during the preference period or in the year prior to the preference period? Explain. Is there any documentation (memos, letters, e-mails, etc.) of the change? How was the change communicated to the debtor?

6. Did your company engage in any unusual collection activity during, or immediately prior to, the preference period? Cessation of shipments? Threatening collection phone calls or correspondence? Describe in detail and provide copies of all related correspondence.

7. How are credit memos handled with this debtor, including timing of returns and credits and payments of advertising co-op payments, if any? Is this typical of the procedure your company uses with other customers?

8. What is the timing between the date an invoice is prepared and the date related product is shipped?

9. Did the debtor pay for goods shipped/services provided during the preference period? Be prepared to identify by (I) invoice number, date and amount and (ii) check number, check amount and deposit date.

10. Has a proof of claim been filed? If not, why not?

11. Did you receive financial statements from the Debtor in the six months prior to the bankruptcy filing, or did you receive any other information or assurances from the Debtor during that time indicating that the Debtor was financially sound?

12. Are there other facts that might indicate that your preference period transactions with the debtor took place in the ordinary course of business? Explain.

Ordinary Course of Business Work Sheet

[illegible]

NOTE TO PREPARER:

The information you provide in this worksheet will enable us to determine the ordinary course of your company's business with the debtor by calculating the time period(s) within which the debtor typically pays your invoices. Information should be provided on an invoice-by-invoice basis, beginning with invoices paid for with payments received 15 months prior to the date the debtor filed its bankruptcy petition. The information should be forwarded to us by e-mail in Microsoft Excel format, if possible.

New Value Worksheet

[illegible]

NOTE TO PREPARER:

This worksheet is intended to show the chronology of payments received and shipments made during the Preference Period. Each individual payment (by check, wire or otherwise) received during the Preference Period, and each shipment made during the Preference Period, should be listed chronologically. The information should be forwarded to us by e-mail in Microsoft Excel format, if possible.

Preventative Preferential Transfer Measures

(Not “Mission Impossible”)

- Third Party Payment (i.e. affiliate, principal, etc.)
- Third Party Guaranty constituting “primary obligor”
- Preference Indemnity
- PMSI
- Use of ordinary course exception
 - (a) representations
 - (b) regular scheduled payments
- Ship on consignment
- Fill orders via nearby warehouse via same day/COD -
- “Contemporaneous Exchange”

- Bursting Insolvency Presumption
 - (a) 90 day insolvency presumption - debtor trustee does not have to prove insolvency.
 - (b) unless other evidence of solvency such as letter, financial statement, etc.
 - (c) bursting insolvency changes dynamics significantly
- Settlement documentation
 - Full amount due until (i) pay \$x and (ii) 91 days have elapsed without a voluntary or involuntary bankruptcy being commenced.

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