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REPORT FROM COUNSEL

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MANAGING EXPOSURE AS A TRADE CREDITOR

By Eric C. Springer, Esquire and Patrick W. Carothers, Esquire

With the recent bankruptcy filings of both LTV and Wheeling-Pittsburgh Steel Corporation, companies supplying goods and materials are being faced with potentially large unsecured trade debt claims which may force their own companies to the brink of bankruptcy if unpaid. As economic growth slows, trade creditors should regard LTV and Wheeling Pitt as a warning that a challenging period has begun. Companies which rely on orders from buyers either on the brink of bankruptcy or those that have already filed bankruptcy need to be prepared to deal with a potentially insolvent or bankrupt buyer and to be aware of ways they can attempt to avoid or minimize their exposure.

A trade creditor is often faced with the challenge of maintaining a customer relationship while aggressively pursuing payment. The trade creditor frequently can neither afford to lose a customer nor write-off accounts receivable.

A trade creditor may have a number of options available, short of termination. Many of the options; however, may depend on the leverage the trade creditor is able to exert against the buyer (which may ultimately depend on their willingness to walk away from the customer relationship). In any event, it will be critical that the trade creditor closely monitors the status of the buyer, any shipments and the payment of accounts receivable. Such monitoring is so important that the trade creditor should consider outside assistance

(such as retaining an accounts receivable management firm) if internal resources are unavailable.

The ideal alternative for the trade creditor is to receive cash upon or before delivery. "Cash" really means cash, because a debtor's check on its operating account might not clear due to judgment attachment, bankruptcy, stopped payment or insufficient funds. Buyers typically are opposed to this proposal unless they are desperate for the goods involved and cannot find a suitable or timely replacement. Under those circumstances, the trade creditor pulling the trigger to require cash may have just seen the last order from the buyer. While the trade creditor might offer the buyer a discount for accepting the cash payment requirement, the discount could prompt the buyer to question the trade creditor's pricing and profit and may affect negotiation and pricing on future orders.

Trade creditors may also attempt to negotiate to obtain security from the buyer to cover losses upon default. By obtaining a security interest in collateral, the trade creditor will have recourse against collateral to liquidate as payment for unpaid amounts due. The trade creditor with a perfected security interest may stand in a better position to other creditors in a buyer's bankruptcy, depending on the relative priority of its claim and the value of the collateral.

A trade creditor may obtain security in several different manners. Most commonly, the trade creditor could take a security interest in the actual goods shipped to the buyer or other specifically described collateral. If the buyer defaults on payment, the trade creditor has a right to retake the goods. However, this may not be a feasible approach if the buyer incorporates the goods as a part of a whole product, which may affect the priority of the trade creditor's security interest. The security interest may also be subordinate to a blanket lien by the buyer's funding source. Further, if the trade creditor can only reclaim the goods sold, it may be in no better position if it is unable to resell such goods (such as specially-manufactured goods) to another customer.

In order to take full advantage of the possibility of a security interest, the seller needs information about the status of liens against the buyer's inventory (in order to send a notice to any creditor having a lien of record on the buyer's inventory), a security agreement and financing statements signed by the buyer (which will need to be recorded). Time pressures rarely permit for all of this work to be completed in time. The buyer may also be reluctant to grant a security interest and/or file financing statements. The buyer may fear not having complete control over its goods or inventory. Further, the buyer may be subject to existing loan covenants that prohibit the buyer from granting a security interest to a third-party. Additionally, if a financing statement is filed by the trade creditor, other parties will have notice as to the grant of the security interest. The buyer may fear that other suppliers would learn of the arrangement and demand security for their transactions.

An attractive option might be to ship goods to a warehouse located in close proximity to the buyer's place of business. The trade creditor, in that case, would retain possession of the goods through an agent of the trade creditor who will be in control of the goods once

at the warehouse. The trade creditor would retain the warehouse receipt for the goods in the warehouse. When the buyer pays the entire or a negotiated percentage of the price, the trade creditor will give the warehouse receipts to the buyer and the agent will release the goods. Under this procedure, a financing statement does not have to be filed since the trade creditor remains in possession of the collateral. Therefore, the buyer's other suppliers would not be on notice of the arrangement. The buyer may be in favor of this option because the goods are readily accessible and the buyer can delay payment until it is in need or ready to use the goods involved. From a trade creditor's perspective, the additional shipping and storage costs may be a drawback to using this approach.

Similarly, a trade creditor may consider the use of a broker or a factor. A broker who is willing to risk the buyer's insolvency would buy goods at a discount for resale to the buyer. The broker will then sell the goods to the buyer and retain the risk of loss. The trade creditor's profit will, of course, be adversely affected by the amount of the discount.

The trade creditor may also be able to secure its position with a third-party guarantee. A third-party guarantee may be feasible when dealing with a small closely-held company but is unlikely to be considered by a larger buyer. In rare instances, the buyer may also be a supplier of goods to the trade creditor, in which case the two parties could enter into a "swap" or set-off transaction. There, each party supplies the other with goods and to the extent that a party defaults, the other party can reduce the amount it owes for goods supplied by the amount owed to it.

In addition to structuring a pre-petition strategy for the continued sale of goods to a troubled buyer, the trade creditor must also be aware of the concept of "preferences". A preference is a transfer of money or property or the giving of a lien that can be "avoided" or reclaimed from the trade creditor if the buyer files for bankruptcy. Generally, a preference is a transfer or payment made by the debtor outside the ordinary course of business and not in direct exchange for goods received. Payments are permissible if they are being made for new consideration received or are being made at a time when a payment is usually made. If payments are received for other reasons (or no reason) or at other times, they may be viewed as a preference because they have the effect of aiding one creditor at the expense of another. Such payments will be taken from the person who received them and returned to the bankruptcy estate for the benefit of all creditors. It is important to note that it is not illegal to accept a preferential payment, but trade creditors need to be aware that such a payment may need to be returned.

After the buyer files for bankruptcy under Chapter 11, several new issues confront the trade creditor. If the buyer is still in business, the trade creditor may still want to do business with it. However, dealing with a company in Chapter 11 can be complicated due to the constraints of the bankruptcy code and the unpredictability of the buyer's financial future.

A trade creditor has some remedies available under the bankruptcy code. For example, the trade creditor may have the right to stop delivery of goods in transit or to make written demand for the return of goods if the buyer received the goods within 10 days

before the buyer files for bankruptcy. This remedy will be lost unless the trade creditor acts quickly and has the knowledge of recent transaction history (such as recent shipments) readily available to make the demand.

Upon receiving notice that the buyer has filed for Chapter 11 protection, the trade creditor should immediately suspend any pending deliveries to the buyer. Transactions between a seller of goods and a debtor in bankruptcy are subject to the provisions of the bankruptcy code, as well as contracts governing the sale of goods and the provisions of the uniform commercial code regulating the sale of goods. Usually, the provisions of the bankruptcy code will control provisions of contracts or the uniform commercial code. The bankruptcy code permits a bankrupt buyer to maintain an open account relationship with its trade creditors. The bankruptcy code provides that creditors providing unsecured post-petition credit to the bankrupt buyer are to be paid ahead of any other unsecured creditors. While this is comforting to know, this administrative claim priority will be of little value if there are no unencumbered assets or the debtor cannot make money even with bankruptcy protection.

The trade creditor is not obligated to offer an open account arrangement to a bankrupt buyer. The trade creditor should instead consider obtaining a security interest, a letter of credit, or cash in advance before shipping. In some cases, however, the bankruptcy court may need to authorize arrangements other than an open account relationship. There, if the bankrupt buyer's restructuring attempt fails, the trade creditor will be paid in accordance with the terms agreed to and authorized by the bankruptcy court and will be afforded greater priority than as a general unsecured creditor for the post-petition liability incurred.

A trade creditor may not, however, "catch-up" on pre-petition losses by inflating post-petition invoices. At least one bankruptcy court has held trade creditors liable for conspiracy to aid and abet a debtor's breach of fiduciary duty for paying inflated invoices for post-petition services to assist the trade creditor indirectly to recover pre-petition losses or provide inappropriate post-petition incentives. There the court ordered that the funds received be returned.

The trade creditor also must be concerned with outstanding contracts it has with the bankrupt buyer. The bankruptcy code gives the bankrupt buyer the right to assume or reject any such executory contracts. If the bankrupt buyer assumes the contract, the trade creditor will continue to have the rights and obligations it has under such contract. If the bankrupt buyer rejects the contract, the trade creditor's rights and duties under the contract will be discharged. The only remedy the trade creditor retains is the right to bring a cause of action against the bankrupt buyer for breach of contract, which may have little or no value.

As a creditor of the bankrupt buyer, the trade creditor will have the right to vote for or against confirmation of the Chapter 11 plan of reorganization. Creditors with the largest unsecured claims against the debtor may be permitted to participate in the formulation of the Chapter 11 plan of reorganization, as part of the Official Committee of Unsecured

Creditors. Monitoring the bankruptcy case is essential if the trade creditor hopes to manage its exposure to loss during the post-petition period and to maximize the recovery of pre-petition amounts owed to it.

In sum, exposure can be great for those who fail to take precautions. Loss can be minimized by those who have a plan to deal with the troubled buyer. The assistance of counsel familiar with the legal aspects of insolvency is a necessary component of any attempt to manage this exposure.

About the Authors

Mr. Springer is a shareholder and director of the firm and a member of the firm's Corporate, Financial and Litigation Services Groups. Mr. Springer's practice includes mergers and acquisitions; corporate, limited liability company and partnership formation and restructure; commercial transactions; employment law; general bank counseling; commercial loan origination, workout and restructure; loan portfolio sales and acquisitions; creditor's rights including bankruptcy, collection, foreclosure and liquidation. Mr. Springer is a cum laude graduate of Allegheny College and he received his juris doctorate from Duquesne University. Mr. Springer was formerly Vice President and Associate General Counsel of the Federal Home Loan Bank of Pittsburgh. He has served as corporate fundraising member of the American Heart Association and he serves on the Board of Directors of HEARTH (formerly North Hills Affordable Housing) as well as on its Finance and Community Housing Development Committees.

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NOTES ON RECENT COURT DECISIONS

By Anthony J. Valenti, Esquire

Ignore the Fine Print at Your Peril

How many people read the seemingly endless "fine print" which is emblazoned on nearly every scrap of paper today? For most people, this fine print is just background noise. And, for most of those people, that is about the extent of the effect all of the fine print has on them. But, for a business, as one Pennsylvania corporation found out, treating the fine print as background noise can be a big mistake.

In December of 1997, Todd Heller, Inc., a company engaged in the glass recycling business, bid on a contract with the Indiana Department of Transportation to supply glass

beads to be used in the making of reflective highway paint. Under the terms of the bidding requirements, the company was required to ship the bidding documents and samples of the glass beads in specified amounts by a certain date. The day before the deadline, the beads were shipped via United Parcel Service under the terms of its standard overnight shipping terms. These shipping terms were contained in UPS's preprinted form, which apparently went unread by the company's employees.

As it turned out, UPS made an error and only delivered three of the four boxes, thus resulting in the company's disqualification from the bidding process. The fourth box was delivered the day after the deadline. The company's bid was the lowest one received and, because public contracts are awarded to the lowest bidder, it would likely have been successful.

This was no small contract. In fact, the company stood to earn profits in the amount of $395,582. UPS defended, on the grounds that the shipping contract contained a limitation of liability clause which provided that unless the shipper (in this case, Todd Heller, Inc.) declares otherwise, the value of the item to be shipped is $100, and that UPS shall not be held liable for any damages above that amount. Based upon this defense, the trial court ruled in favor of UPS and granted damages in the amount of $100 to the company.

On appeal, the Pennsylvania Superior Court upheld this limitation of liability, stating that the instructions were clear and that the shipper had a reasonable opportunity to declare the packages to be of a greater value. The court rejected the company's argument that the limitation of liability language was not conspicuous enough. The court was further persuaded by the fact that the company, being a business, was, or should have been, familiar with regular business practices associated with shipping items.

Thus, businesses, as well as individuals, ignore the fine print in contracts at their peril. The Todd Heller, Inc., case clearly illustrates that the courts will hold the parties to the terms spelled out in the fine print, and this is especially true when the party shipping goods is a business.

The Telephone Company May Have Enforceable Rights on Your Land

A recent Pennsylvania Superior Court case illustrates how the new communication equipment being installed in our homes, such as DSL lines for high-speed Internet access, multiple telephone lines, cable Internet service, and digital television, may have the effect of giving the telephone company certain rights on the use of our land. In *The Morning Call, Inc. v. Bell Atlantic-Pennsylvania, Inc.*, the landowner, in connection with the demolition of a building, sought to have Bell Atlantic-Pennsylvania remove its telephone equipment which serviced that building and adjacent buildings. The issue brought before the court was whether Bell Atlantic could force the landowner to pay the costs that Bell Atlantic would incur in relocating the telephone equipment. The resolution of that issue turned on whether Bell Atlantic had a right to keep its equipment on the land.

The facts of the case present a common situation. In 1917, the predecessor company to Bell Atlantic-Pennsylvania, Bell Telephone, attached telephone equipment to the landowner's properties to provide telephone service to those buildings and to adjacent row homes. The telephone service had been continuously used and maintained on the property since 1917 and was upgraded in 1982. There was no question that the equipment was visible from the exterior of the building, and that the landowner was obviously aware of the telephone service. However, neither the landowner nor Bell Atlantic could produce any documents showing that Bell Atlantic had the right to install the telephone equipment on the property initially or the right to maintain the equipment thereafter.

The superior court held that the landowner was required to compensate Bell Atlantic for the cost of relocating the equipment, totaling $8,276. In doing so, the court held that Bell Atlantic had an "irrevocable license" to place and keep its equipment on the building. The law defines a "license" as a personal or revocable privilege to perform an act or a series of acts on the land of another. A license may become irrevocable when the party having the license expends money in reliance on the right. Furthermore, successors in title to the property, which is now burdened by this irrevocable license, are subject to it if they had notice of it prior to their purchase.

In holding that Bell Atlantic has an irrevocable license to maintain and update the equipment on the building and that successive owners with knowledge are subject to it, the court was persuaded by the fact that Bell Atlantic's use of the land was permissive in 1917, that it was specific only to providing telephone service, that the actual burden upon the land was minimal, that the property in, fact, benefited from the telephone service, and that Bell Atlantic continuously maintained and updated its equipment. Thus, each and every owner of the property from 1917 to the present took the land subject to Bell Atlantic's rights.

This very same situation may arise anytime a landowner wishes to take any action with regard to a building which will require the telephone company to either remove the telephone service or relocate it. Holding a landowner liable for the payment of such costs is a novel development under Pennsylvania law, and it remains to be seen how the effects of this decision will be limited or expanded in the future. It is clear at this point, however, that the potential costs of such relocation must be taken into account whenever major alterations to existing structures are being planned.

About the Author

Anthony J. Valenti is an associate attorney with the firm and practices exclusively in the area of litigation. Mr. Valenti is a 1995 graduate of the University of Pittsburgh and earned his Juris Doctorate from Duquesne University in 1999. Mr. Valenti was the editor-in-chief of the Duquesne Business Law Journal and a staff writer for both Juris Magazine and the Duquesne Alumni News.

DECENNIAL FILING REQUIREMENT FOR PENNSYLVANIA

The Pennsylvania Corporation Bureau requires every corporation, which is incorporated or qualified to do business in Pennsylvania, to file a Decennial Report of Association Continued Existence if the corporation came into existence prior to January 1, 1990 and if it has not filed an amendment to its articles of incorporation since the date it was incorporated. If the corporation fails to comply with the Decennial Filing procedure by December 31, 2001, the Pennsylvania Corporation Bureau will release the corporation's name, and the name will become available for any other entity to use. If you have not received the proper Decennial Filing form, you may obtain one by contacting us.