



Bankruptcy, Workouts, & Creditors' Rights NEWSLETTER

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Dear Clients and Friends:

Our Bankruptcy, Workouts, & Creditors' Rights practice as we know it is changing fast. As you may know, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Act") became effective in October 2005. The Act significantly revised the Bankruptcy Code – adding a new layer of complexity to certain bankruptcy and creditors' rights issues. The attorneys of Schiff Hardin LLP's Bankruptcy, Workouts, & Creditors' Rights Group studied the changes introduced by the Act and highlighted key issues during the course of 2005 through a series of email Alerts. We trust you found our Alerts useful and informative in assessing the Act's impact on your business and operations.

Following on the success of our Alerts, we decided to launch the Schiff Hardin Bankruptcy, Workouts, & Creditors' Rights Newsletter. Although the Newsletter's format differs from last year's email Alert, our goal remains the same: to provide you with concise and practical information designed to better position and equip your organization as it deals with a myriad of bankruptcy and creditors' rights issues. We recognize, however, that any newsletter or article is invariably limited in scope and often raises more questions for our readers. As a result, we are committed to providing complimentary teach-in seminars and a practical checklist relating to the lead article of each Newsletter. We are hopeful that a combination of the Newsletter articles, checklists, and teach-ins will give you the opportunity to raise questions, discuss issues, and improve your knowledge of bankruptcy and creditors' rights issues. We also hope you find this first issue of the Schiff Hardin Bankruptcy, Workouts, & Creditors' Rights Newsletter useful and informative. Should you have any questions, please do not hesitate to contact any member of our team. You'll find contact information for attorneys in our Bankruptcy, Workouts, & Creditors' Rights Group on the back of this newsletter.

THE PROACTIVE CREDITOR: PRACTICAL TIPS TO MAKE THE MOST OF YOUR CUSTOMER'S BANKRUPTCY FILING

By Jon C. Vigano

A customer's bankruptcy filing is often far from a surprise. Indeed, as a customer slides deeper and deeper into its financial distress, tell-tale signs begin to emerge. Ominous signs may include aging receivables caused by late or broken promises to

pay, rumors of the customer's lack of liquidity, delay in returning phone calls or the issuance of a qualified opinion from the customer's auditors. Although our clients advise us that they are reasonably capable of predicting a customer's financial collapse, we also

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understand that clients are caught not by the surprise of the initial bankruptcy filing, but by what steps to take immediately after receiving notice of a bankruptcy filing. This Spring 2006 issue of Schiff Hardin's Bankruptcy, Workouts, & Creditors' Rights Group Newsletter is dedicated to providing practical tips to avoid this "deer-in-headlights" scenario. In fact, this issue, along with the enclosed Bankruptcy Checklist, is intended to assist our clients in reacting quickly to the dynamic pace of the bankruptcy process—thereby minimizing loss and maximizing opportunities for our clients as they are forced to endure a customer's bankruptcy filing.

1. The Initial Bankruptcy Filing: As suggested above, our clients often are able to predict a customer's financial distress. However knowing when the company's bankruptcy filing actually occurs is an entirely different situation. Traditionally, a bankrupt's creditors receive notice from the relevant bankruptcy court where the debtor filed its bankruptcy petition. Notice is often untimely, though, because it is sent by regular mail. However, if the sum owed by a bankrupt customer constitutes a significant amount of its unsecured debt, you may receive expedited notice of the bankruptcy filing. This notice is usually sent by the debtor's counsel and includes copies of the bankruptcy petition, a list of the top 20 creditors (or sometimes more in a very large bankruptcy case), and an assembly of documents filed with the bankruptcy court that are referred to as "First Day Motions." Receiving a copy of your customer's bankruptcy petition and First Day Motions does not happen by accident. You receive them for a reason. You could be one of your customer's significant creditors or your commercial relationship might be impacted by one of the First Day Motions.

Tip: If you do receive the documents discussed above, it is important to review them immediately, with the assistance of counsel, to assess how your rights are impacted and to have your counsel appear at the

First Day Hearing, if necessary. Although it is often standard practice for many courts to enter interim orders (orders giving relief for only a short duration) relating to the First Day Motions, being aware of what you received will help you react immediately and trigger a process of proactive steps (recommended below) to insure you strengthen your position with respect to your bankrupt customer. Being aware of what you receive will also help you make an early determination of your bankrupt customer's potential success in a chapter 11 bankruptcy context.

2. Assert Your Reclamation Rights: The Act ushered in several significant creditors' rights amendments to the Bankruptcy Code. One such change is in the area of reclamation rights. Today, sellers of goods have more than twice as long to make a reclamation demand to reclaim possession of goods sold to the debtor on credit. As the accompanying article starting on page 8 explains in more detail, a written reclamation demand must be made (i) no later than 45 days after receipt of such goods by the debtor or (ii) no later than 20 days after the commencement of the bankruptcy case, if the 45-day period expires after the commencement of the bankruptcy. You must be vigilant to protect your reclamation rights. Because the deadlines discussed above are time-sensitive and a reclamation demand is only valid to the extent the goods remain in the debtor's possession, a written reclamation demand should be made as soon as reasonably possible.

Tip: In order to increase the effectiveness of your reclamation demand, the written demand should reasonably identify the goods subject to reclamation. If the list of goods is extensive and

would take time to compile, you might consider transmitting an initial reclamation demand and follow up with a supplemental demand incorporating the compiled list of goods sold on credit.

3. Pursue Your Administrative Claim Rights:

The Act also introduced a new administrative claim for goods sold to the debtor in the ordinary course of business within 20 days before the commencement of the bankruptcy case. Unlike a reclamation demand, however, this new administrative claim is not lost for failure to give notice before the reclamation deadlines discussed in number 2 above or before the debtor has resold the goods. In order to take advantage of this administrative claim, a creditor may have to file a request for payment of the administrative claim in the debtor's bankruptcy case.

Tip: In order to avoid tripping over arbitrary administrative claim deadlines of which you might not receive notice, it is advisable to file the request for payment soon after discovering the debtor's bankruptcy filing. Asserting a request for payment of an administrative claim is not like filing a proof of claim. A separate pleading may have to be filed and noticed before the court. It is important to note, however, that while you may have a right to an administrative claim, your rights might be rendered valueless if secured claims against the debtor exceed the value of its assets. But, of course, you will have no rights to this claim if you do not follow the necessary steps outlined above.

4. Review the Debtor's Schedules: A debtor is required to file its schedules, including a schedule identifying its trade claims, reasonably soon after the filing of its bankruptcy petition. At times, especially in larger bankruptcy cases, a

debtor may seek an extended deadline from the bankruptcy court. Regardless of when the debtor files its schedules, it is important to review the schedules for a number of reasons. First, it is important to determine whether you are identified as a creditor. Second, if you are identified as a creditor, it is important to determine whether the amount the debtor suggests it owes you is listed as disputed, contingent or unliquidated.

Tip: When reviewing the debtor's schedules, pay close attention to your address on the schedule. Be sure to identify if the debtor is using a P.O. Box or an old address that is no longer valid. If a debtor identifies an incorrect address or uses a P.O. Box, you are at risk of not receiving future important notices from the debtor, including, but not limited to, the deadline to file a proof of claim. If this situation occurs, we recommend that clients correct the address error by filing a Request for Notice. The Request for Notice can be tailored to provide that any future notices be transmitted to specific individuals within your organization that are assigned to monitor this case, thus alleviating any uncertainty regarding which person within the organization received the notice. Conversely, if the debtor does not list your claim on its schedules, or lists the claim incorrectly, you should consider filing a Proof of Claim in order to assert a claim against the debtor for the prepetition sums due and owing.

5. Review Preference Exposure: Because a preference claim is usually made by the debtor close to the 2-year anniversary of a bankruptcy filing, the element of surprise is a key asset to any party prosecuting preference claims against those creditors receiving payments within 90 days

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prior to the debtor's bankruptcy. Although the Act has significantly enhanced a creditor's rights in asserting an ordinary course of business defense, a creditor's defense is often handicapped by its failure to properly maintain records and correspondence with the debtor.

Tip: Soon after learning of a customer's bankruptcy filing, retrieve and secure your records (i.e., check copies, invoices, packing/shipping slips, emails, letters, etc.) relating to the transactions with the debtor. The information retrieved should be for approximately 15 months prior to the debtor's bankruptcy filing. Also, we recommend performing a proactive preference analysis to determine your organization's estimated preference exposure. By doing so, you can determine whether or not to file a proof of claim or elect not to file a proof of claim in order to protect your right to request a jury trial if and when a preference claim is pursued.

6. Consider Filing a Proof of Claim: Filing a Proof of Claim is the primary method by which a creditor can attempt to collect on prepetition debt without violating the Bankruptcy Code's automatic stay provisions. Under the Bankruptcy Code, a Proof of Claim filed by a creditor is valid unless affirmatively objected to by the debtor. Upon learning of a customer's bankruptcy petition, immediately begin the process of compiling the

information needed to assemble your proof of claim.

Tip: When compiling information for a proof of claim, use the following guidelines: (a) generate a summary list of unpaid, pre-petition invoices; (b) gather and secure copies of all unpaid invoices and bills of lading; and (c) review the debtor's schedules (as discussed in number 4 above). We often recommend filing a Proof of Claim before receiving the official proof of claim form from the bankruptcy court. Before filing a proof of claim, however, it is important to consider your preference exposure because the filing of a proof of claim waives your rights to demand a jury trial in a preference or other case in which you would be entitled to a jury trial. Also, don't forget to identify any other third parties that may also be obligated to pay the debtor's debt. For example, you should consider efforts to collect against a guarantor of the debt or draw on a letter of credit, where applicable.

The six areas of discussion identified above are not intended to exhaust any rights or remedies available to a creditor when first learning of the bankruptcy of its customer. Rather, they are designed to instill a level of vigilance and care in exercising a creditor's rights under the Bankruptcy Code

INTRODUCTION TO PREFERENTIAL TRANSFERS UNDER THE BANKRUPTCY CODE

By J. Mark Fisher and Michelle Fisk

Preferences and Underlying Policy

Creditors are often frustrated by the fact that the Bankruptcy Code ("Code") empowers the trustee to avoid "preferential" transfers made by an insolvent debtor prior to bankruptcy. Two

fundamental policies underpin preference law. First, the recovery of preferences promotes equality in the distribution of the insolvent debtor's assets among creditors who, by aggressive collection efforts or even good luck, were paid-in-full prior to the bankruptcy filing and

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SAVE THE DATE

To further develop and discuss the information outlined in this issue's lead article and the enclosed checklist, the attorneys of Schiff Hardin LLP's **Bankruptcy, Workouts, & Creditors' Rights Group** will be hosting a

Teach-In

“The Proactive Creditor: Practical Tips to Make the Most of Your Customer's Bankruptcy Filing”

at our Chicago office:

66th floor Conference Center
233 S. Wacker Drive
Chicago, IL 60606
t 312.258.5500

May 17, 2006
9:30 a.m. – 11:30 a.m.

If you would like to attend, please log on to <http://www.schiffhardin.com/events/bankruptcy> to register. The deadline to register for the May 17, 2006 Teach-In is May 10, 2006. We look forward to discussing these and other creditors' rights issues with you at that time.



thus would otherwise receive a greater recovery than other creditors will receive in bankruptcy. Second, the preference defenses encourage creditors to continue doing business with the debtor in the ordinary course and to continue providing new value to the bankruptcy estate. These egalitarian policies are often a small consolation to a creditor who is being sued to pay back additional money into the bankruptcy estate when it is already facing a significant write-off due to the debtor's bankruptcy.

Elements of a Preference That a Trustee Must Prove

In order to recover a preference, the trustee (or debtor-in-possession) must establish: (1) a transfer of property in which the debtor has an interest; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) made while the debtor was insolvent; (5) made within 90 days before the filing of the bankruptcy petition, or made within one year of the filing if the benefited creditor was an "insider"; and (6) that enables such creditor to receive more than such creditor would receive in a hypothetical Chapter 7 liquidation. From a creditor's perspective, it is very difficult to prove the absence of a transfer of the debtor's property or that the debtor was not "insolvent" (i.e., that its liabilities exceeded its assets at fair valuation). However, the existence of a security interest or lien, for example, that was perfected for more than 90 days before bankruptcy can rebut the last element, which requires an improvement in the creditor's position in a hypothetical liquidation. Also, payments on a C.O.D. or cash-in-advance basis will negate the element requiring the payments to have been made on account of an "antecedent debt." If a preference is avoided, the creditor may receive a new unsecured claim for the amount paid back. In cases where there is a relatively high projected dividend to unsecured creditors, this new

unsecured claim (and any existing claim) often may be traded away as part of a preference settlement to require less of an out-of-pocket payoff by the creditor.

Preference Defenses That May Protect a Creditor

Given the breadth of the transactions with a financially weak debtor that meet the definition of a preference, most creditors focus on the following preference exceptions, any one of which can protect a transfer from avoidance:

1. Contemporaneous Exchange for New Value. A transfer that is both (i) intended to be a contemporaneous exchange for new value and (ii) in fact is a substantially contemporaneous exchange for new value is exempted from preference avoidance. C.O.D. payments and checks that meet both these elements qualify for this protection. "Trading" payments due for past shipments in exchange for an equal quantity of new deliveries may also be protected. Post-dated checks, however, are not protected from avoidance because they fail to meet both elements of the contemporaneous exchange for new value defense.

2. Subsequent New Value. A preferential transfer will not be avoidable to the extent that the transferee, after receiving such transfer, gives new value to or for the benefit of the debtor on an unsecured basis. For example, if a creditor receives a \$10,000 payment during the preference period that meets the other elements of a preference and subsequently, during the preference period, ships \$5,000 of new goods for which the debtor does not pay, that creditor's preference liability will be reduced by \$5,000. Theoretically, a creditor repays a prior preference if it later extends new unsecured loans or gives other value to the debtor which is not repaid. Payments on the debtor's obligations to third parties are

included in this defense as well. Unfortunately, a creditor cannot count new value extended prior to an avoidable preference payment or new value extended after the bankruptcy filing (although such post-bankruptcy credit is entitled to an administrative priority).

3. Ordinary Course of Business. A transfer is not avoidable as a preference if it is a payment of a debt that was either (a) incurred in the ordinary course between a party and the debtor, or (b) made according to ordinary business terms (i.e., ordinary terms according to the industry standard). Preference defendants formerly had to meet both of these standards and frequently could not satisfy the industry standard. Under the new revisions to the Code, however, only one of these elements must be met by the creditor defending a preference claim.

4. Enabling Loans. Legitimate “enabling loans” are protected from preference avoidance if the creditor receives a security interest that (i) secures new value, and (ii) is given to enable, and is in fact used by, the debtor to acquire specific property if the security interest is perfected within 30 days from the time it was created.

5. No Improvement of Position in Receivable and Inventory Financing. A payment will not be avoidable if the transfer created a perfected security interest in the debtor’s inventory or receivables, except to the extent that the secured creditor improves his position (i.e., experiences a reduction of the amount by which the initially existing debt exceeded the security) (i) during the preference period, or (ii) from the date during the preference period on which new value was given under the security agreement. Some courts protect payments made under such lending arrangements even though this circumstance expressly applies only to creation of security interests.

6. Statutory Liens. Generally, a statutory lien cannot be avoided as a preference. However, a trustee may avoid statutory liens on the debtor’s property to the extent that (i) the lien first becomes effective when a bankruptcy case or other insolvency proceeding of the debtor is commenced, when the debtor becomes insolvent, when a custodian is appointed to take possession of the debtor’s property, when the debtor’s financial condition fails to meet a specified standard, or when execution against property of the debtor is levied by an entity other than the holder of the statutory lien, or (ii) the lien is not perfected or enforceable at the commencement of the case against a hypothetical bona fide purchaser of the property at the commencement of the case.

7. Other Limitations on Small Preference Claims. The Code creates a defense for a preference claim that seeks to recover a transfer of less than \$5,000. It is important to note that this limitation does not prevent a debtor from sending a demand letter for less than \$5,000. Any party receiving such a demand should consult with counsel rather than simply paying the demand in order to quickly resolve the matter. Actions seeking to recover sums of less than \$10,000 may only be brought in the district where the defendant resides.

Statute of Limitations

Preference avoidance actions may not be commenced after the earlier of (1) two years after the commencement of the bankruptcy case or (2) the time the case is closed or dismissed. If a trustee is appointed (which occurs automatically in a Chapter 7 case and infrequently in a Chapter 11 case), however, the statute of limitations is extended to 1 year after the appointment of the trustee if the two-year period otherwise would have expired.

Preferential Transfers continued on page 8



Practical Tips for Creditors Regarding Preference Exposure

- Be aware of the possibility of third-party or earmarked payments of past-due debt. Make sure that all aspects of such transactions are adequately documented.
- Cash checks from the Debtor as soon as possible to maximize the likelihood that the transfer will occur outside of the 90-day (or one year, in the case of an insider) preference period. Other payment mechanisms to minimize float should be considered such as ACH or similar electronic transfer.
- Consider the subsequent new value, setoff, and contemporaneous exchange provisions of the Code in the timing of shipments, payments, and application of credits due to the Debtor.
- Keep a record of postmark dates on check envelopes and dates of receipt of such checks as evidence of transfer dates for purposes of the ordinary course of business defense.
- Be aware that an adjustment of payment practices on pre-existing debt may limit the ordinary course exception.
- Make sure that enabling loan security interests are perfected within 30 days. Frequently audit inventory collateral to record the level of collateral securing the loan.
- Always take a potential preference payment, if offered. If the applicable time limit passes or if some other defense is applicable, then the preference will not have to be returned. If a preference is avoided, however, a creditor's only liability is repayment of the preference amount (plus applicable interest).
- Eliminate any preference exposure by requiring prepayments for any future orders. A prepayment is not an extension of credit or payment of an antecedent debt. Therefore, it does not meet a critical element required to trigger preference exposure. Proactive initiatives to defeat one of the elements of a preference is the best defense.

RIGHTS OF TRADE CREDITORS UPON DISCOVERY OF INSOLVENCY OR BANKRUPTCY OF DEBTOR

By J. Mark Fisher and Michelle Fisk

As we initially raised in our lead article, an unsecured trade creditor should not be caught like a “deer in headlights” when it discovers that its customer is insolvent or bankrupt. Prompt action under the applicable Uniform Commercial Code (“UCC”) and the Bankruptcy Code (“Code”) can allow the reclamation of recently sold goods, stoppage of goods in transit before delivery to the customer and even an administrative priority claim in bankruptcy. Preparation is key because

time is of the essence when invoking these remedies. The creditor needs some basis to determine that its customer cannot pay its debts when they are due or has liabilities in excess of its assets at fair valuation. Indeed, creditors should be vigilant regarding the solvency of their debtors and should take care not to establish a course of dealing or course of performance of shipping on open credit terms to a debtor that acknowledges its insolvency or clearly has become insolvent. In

fact, it may be risky to abruptly cut off credit if such a pattern has become part of your course of dealing with the debtor.

UCC Remedies

Insolvent Buyer. A creditor with unsecured credit terms of sale may nevertheless require cash payment from an insolvent debtor for undelivered shipments and for previous shipments and reclaim goods recently delivered during the period of insolvency.

Creditor's Insecurity Regarding Future Payment. A creditor may demand adequate assurance of a debtor's performance under a contract if reasonable grounds for insecurity arise with respect to the debtor's ability to pay. A creditor may suspend performance pending receipt of such assurance and may file suit for breach if the debtor does not adequately respond within thirty days or shorter periods set forth in the contract governing the transactions or applicable law.

Nonpayment. A creditor has other remedies if payment is not made regarding any shipment, a check is returned N.S.F., payment is past due, or the creditor's contract is otherwise breached (e.g., by failure to provide adequate assurance of payment). These remedies include: (1) withholding delivery by the creditor pending cash payment or other adequate assurance of future performance; (2) stopping delivery of goods in transit; (3) completing unfinished goods and identifying them to the contract; (4) reclaiming goods that were recently delivered to the debtor and have not been resold; (5) requiring payment directly from the customer of the debtor; (6) canceling the order or agreement; (7) reselling the goods plus recovering damages; (8) recovering damages for nonacceptance or repudiation; (9) recovering lost profits; (10) recovering the contract price in some instances; (11) obtaining specific performance if the goods are custom designed; (12) recovering liquidated damages;

or (13) recovering damages in any manner that is reasonable under the circumstances.

Material Breach of Installment Contract. If the breach by the debtor impairs the value of the remaining portions of an installment contract, the creditor can exercise its remedies as to the undelivered portions of the contract.

Stoppage of Goods in Transit. Under the UCC, a creditor has a right to stop delivery of goods in the possession of a carrier, warehouse, or other bailee if a debtor is insolvent, if the debtor fails to make payments when due before delivery, or if for any other reason the creditor has a right to withhold or reclaim the goods. The result of a properly effected stoppage in transit is to revest a lien in the goods in favor of the creditor. Title to the goods (e.g., sale F.O.B. Seller's plant) and the status of the remaining deliveries under contract remain unchanged unless the creditor cancels the contract for breach. The carrier or other bailee has a superior lien for accrued transportation and storage charges incurred on the particular shipment. The creditor could be held liable for all later charges and additional expenses resulting from the stoppage order, including damages if the stoppage is improper. After notification, the carrier or bailee acts as the creditor's agent for retaining possession and making further deliveries.

Reclamation of Goods. Under the UCC (Illinois and most states), a creditor who sells on credit may make a written demand on the debtor (and all separately incorporated affiliates) for the return of goods actually received by an insolvent debtor within the last 10 days. If a false financial statement showing solvency was provided within the last 3 months of shipping goods, the 10-day period does not apply. Goods also may be reclaimed if a creditor delivers goods against delivery of a check and the check is returned N.S.F.

A creditor should deliver its reclamation demand to the debtor as soon as the creditor makes a good faith decision that the debtor is

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insolvent. While most reclamation demands apply to goods sold on credit, a creditor can also reclaim goods sold on C.O.D. terms if the check given in payment is returned for insufficient funds. A proper reclamation demand would vest in the creditor the right of ownership and possession of the goods which the debtor physically received during a reasonable period preceding the demand. A creditor's right to reclaim goods does not depend on whether title or risk or loss of the goods has passed to the debtor (e.g., sale F.O.B. Seller's plant) or whether the goods have arrived at the destination point. A suit for replevin and conversion may be required if the debtor dishonors a pre-bankruptcy demand.

Bankruptcy Remedies

Reclamation Right. Once a debtor files for bankruptcy, the Code is a creditor's exclusive source for a reclamation remedy and trumps state law. The Code reaches back further than the UCC reclamation right because it requires that a reclamation demand be made (i) within 45 days after receipt of such goods by the debtor, or, (ii) if the 45-day period expires after the commencement of the bankruptcy, not later than 20 days after the commencement of the bankruptcy case. Unlike the remedy provided by the UCC, however, a creditor only may reclaim goods sold in the ordinary course of business to a debtor who received the goods at a time when the debtor was insolvent under the "balance sheet" definition used by the Code. This test of insolvency may be harder to prove than the failure of the debtor to pay its debts when due; however, there is no harm in making the demand as very few bankrupt companies are solvent under any insolvency test. More importantly, the reach-back period would be substantially longer than the most commonly applicable UCC reclamation provisions. However, the Code makes it clear that the rights of a perfected security interest in inventory will block reclamation, leaving the reclaiming creditor only with a right to pursue an administrative claim. This provision, which codifies the majority rule under UCC reclamation

law, will limit the rights of creditors of most middle-market debtors who have granted blanket security interests to their lenders.

Administrative Priority Claim. If the reclamation claim is unsuccessful, the Code allows the creditor to demand administrative priority (the same as the debtor's attorneys' have) for goods shipped to the debtor within 20 days prior to bankruptcy.

Involuntary Bankruptcy Petition Against Debtor. Particularly if a creditor fears that its debtor, who cannot pay its debts generally, has made payments or transfers of security interests or property to other creditors or insiders, it may benefit from a bankruptcy filing, after which such transfers are halted, preferences and fraudulent transfers can be avoided and the assets of the estate are liquidated pro rata. If a debtor has more than twelve creditors, three or more creditors holding an aggregate of \$12,300 in claims (in excess of the value of any collateral) may file an involuntary petition if (a) the debtor is generally not paying its debts as they become due or (b) a non-bankruptcy custodian (such as a state court receiver or an assignee for the benefit of creditors) is appointed or took possession of substantially all of the debtor's property within the preceding 120 days. Creditors must be very careful in following this strategy because the commencement of a bankruptcy which is held to be defective and in bad faith can expose the creditor to substantial actual and punitive damages.

Other State Law Remedies

Setoff of Mutually Owing Debts. Most states permit a creditor to offset mutually owing (1) matured, liquidated, pre-bankruptcy debts which it owes to a debtor (the "Debts") against (2) matured, liquidated claims of the creditor against the debtor (the "Claims"). Creditors should consider, however, explicitly providing for setoff rights in their contract with the debtor, particularly for unmatured and contingent rights to avoid

delays and uncertainty. Once the debtor is bankrupt, offsets are barred by the automatic stay and are invalid unless the Debts and Claims are “mutually owing” between the same entities and both the Debts and the Claims arise either prepetition or postpetition. To be offset, the Debts and Claims need not arise out of the same contract or transaction or be of the same type (e.g., tort or contract). The Code also discourages prepetition offsets, which can destroy the debtor’s liquidity and force a bankruptcy. Similar to a preference claim, the trustee can recover from a creditor the amount by which the creditor improves his position by taking a prepetition offset. The trustee may recover the amount by which any “collateral insufficiency” (excess of creditor’s “Claim” over the “Debt” it owes) on the date of the setoff is less than the insufficiency on the later of (a) 90 days prior to bankruptcy or (b) the first date during that period on which such an insufficiency existed. While the creditor must get relief from the automatic stay to take a postpetition offset, there is no right to recover any reduction in insufficiency.

Recoupment. Although there is a considerable difference of opinion among the courts, a creditor should consider whether the assertion of the defense of “recoupment” is more advantageous than the right of setoff. Recoupment is an equitable defense to the debtor’s enforcement of its Debts against the creditor because the debtor has breached the same agreement or, in the same transaction, has created Claims in favor of the creditor. In contrast to setoff, recoupment requires the creditor to do nothing — it merely refuses to pay. Some courts hold that recoupment rights are not subject to the automatic stay or subject to the requirement that the Claim and Debt both arise before bankruptcy or after bankruptcy.

Obtain Purchase Money Security Interest. The creditor who finances the purchase of goods made by itself or third parties also should consider obtaining a purchase money

security interest from the debtor to secure credit extended for new shipments.

Preparation is Key

Information/Record Keeping. Based on the size of its exposure as an unsecured trade creditor and the expected costs, the creditor should make efforts to obtain the most recent and detailed information on sales to the debtor, goods in transit, the debtor’s financial condition, the debtor’s relationship with secured lenders, and the debtor’s security arrangements, payment terms and its course of dealing with its other important trade creditors. One source of such information may be industry credit managers groups or an informal committee created by the debtor’s trade creditors. The creditor should determine whether such a committee exists and may want to consider participating in its activities or making arrangements to obtain information from the committee.

Have Forms and Shipment Data Handy. Time is of the essence when exercising your rights and remedies discussed in this article. Chances of any recovery decrease with each day that passes after a shipment due to the resale or encumbrance of goods received by the debtor. Good planning and coordination among the credit department and counsel can ensure that, upon receipt of reliable intelligence, timely action can be taken. We would be happy to discuss how to prepare sample form documents relating to the UCC and Code rights discussed in this article that can be quickly modified in the event a need to exercise your rights arises.

For reprints of this newsletter, permission to reprint any of the articles, or to be added to our mailing list, please contact Jon Vigano at jvigano@schiffhardin.com or 312.258.5792. We welcome any feedback.

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Bankruptcy, Workouts, & Creditors' Rights

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THE PROACTIVE CREDITOR: PRACTICAL TIPS TO MAKE THE MOST OF YOUR CUSTOMER'S BANKRUPTCY FILING

A Complimentary Schiff Hardin LLP Bankruptcy, Workouts, & Creditors' Rights Group Checklist

1. Confirm Initial Filing

- Alert appropriate internal personnel (credit department, sales teams, etc.)
- Identify critical information relating to filing (i.e., case number, jurisdiction, debtor's counsel)
- Review bankruptcy petition to determine if your organization is listed as a top 20 creditor
- If you are a top 20 creditor, consider applying for membership in the Unsecured Creditors' Committee, if one is organized by the United States Trustee
- Review First Day Motions for impact on your organization
- Review First Day Motions for an early determination of the potential success in a chapter 11 context

2. Reclamation Issues

- Do you have a reclamation claim to assert?
- If yes, promptly transmit a "Reclamation Letter"
- Assemble documents and data to support reclamation claim

3. Administrative Claim Issues

- Did you sell goods to the debtor in the ordinary course of business within 20 days before the filing of the bankruptcy case?
- If yes, assemble documents and data to support Administrative Claim
- File Request for Administrative Claim in appropriate bankruptcy case as soon as possible

4. Debtor's Schedules

- Did the debtor file its schedules with its bankruptcy petition?
- If yes, confirm debtor's obligations to you are listed correctly (i.e., amount, secured vs. unsecured, disputed, contingent, or unliquidated, etc.)

- Confirm debtor identifies your proper mailing address (no P.O. Boxes), if not, file a Request for Notice with the Bankruptcy Court
- Confirm your debt is not listed as contingent, disputed or estimated
- Record deadline to file proof of claim if debtor receives authority from the court to file late schedules

5. Preference Exposure Issues

- Retrieve and secure records (i.e., invoices, packing/shipping slips, check copies, emails, etc.) relating to transaction with the debtor
- Information retrieved (or at least preserved) should be for approximately 15 months prior to the debtor's bankruptcy filing
- Consider proactive preference analysis to determine potential exposure and proof of claim strategy

6. Proof of Claim Issues

- File proof of claim before receiving official form from the bankruptcy court
- Before filing, however, (i) consider potential preference exposure and (ii) determine if you agree with debtor's schedules (since claim may be unnecessary)
- Consider pursuing other third parties obligated under the debt
- Determine value of claim – for claims sale purposes (to consider if you want to sell your claim)

7. Miscellaneous Considerations

- Consider a Motion Requesting Service of All Pleadings or authorize counsel to receive and monitor case via e-filing
- Consider authorizing counsel to file an appearance on your behalf
- If your prepetition claim against the debtor is significant, consider monitoring the debtor's case for any "critical vendor" motions and, where appropriate, raise objection to same if you are not identified as a critical vendor



Schiff Hardin represents clients on all sides of corporate reorganizations, restructurings, workouts, liquidations, foreclosures, and bankruptcies. This includes debtors, secured and unsecured lenders, major trade creditors, lessors, and committees of unsecured creditors and equity holders.

Our trial lawyers have successfully litigated lender liability, fraud, fraudulent transfer, and preference cases in all levels of the federal and state judicial systems.

We represent clients who initially hire us for bankruptcy matters, as well as regular firm clients who are landlords or institutional lenders, in secured and unsecured financing, real estate lending, floor plan financing, venture capital lending, and leveraged buyout financing.

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