Blakeley | Blakeley LLP

BLAKELEY & BLAKELEY QUARTERLY

Volume 1, Issue 1 Winter 2011

B&B DEVELOPMENTS: Recently added a **New York Office** location with two licensed attorneys. The office can be found at 100 Park Avenue, Suite 1600, New York, New York 10017. Phone: 212-984-1033 | Fax: 212-880-6499

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

Scott E. Blakeley, Esq.
&
David M. Mannion, Esq.

Trade creditors can no longer assume that trade credit extended to a municipality is risk free. Bankruptcies filed under Chapter 9 of the Bankruptcy Code, which allows municipalities to discharge debts and reorganize, are becoming more common as the financial crisis continues to affect counties, cities, and agencies. Even the propriety of a State being eligible to file Chapter 9 is being debated. This article considers the recent headlines of the debate of a municipality evaluating a Chapter 9 filing, a Chapter 9 in action, and the impact trade creditor extending credit. The article also considers the federal debate of States being eligible to file Chapter 9. The article also considers whether the trade creditor should reevaluate the amount of their credit lines to municipalities and public agencies, as well as the percentage of their accounts they have with these agencies.

A State in Bankruptcy?

Rarely has the topic of bankruptcy captured the attention of the public in the same way as the debate concerning a possible State bankruptcy scheme. With States laboring under the weight of bloated deficits and unsustainable public compensation schemes, coupled with a growing sense of frustration among private sector constituents who have been hit hard by the recession, a perfect storm has been brewing. Hamstrung by the uncompromising demands of public sector

(Continued on page 4)

The Final Word on the Contract Assumption Defense to Preference Action

Bradley D. Blakeley, Esq.

When a creditor provides services to a debtor, one of the considerations given is whether such services should be done on a long-term contract basis. One of the benefits can be that such contracts, if assumed by the debtor postpetition, can insulate the creditor from preference exposure. Such is the case in the recent decision from the Colorado bankruptcy court in Centrix Financial, LLC.

In Centrix, the debtors sold their assets and the liquidating trustee filed an action to recover nine transfers to the defendant totaling in excess of $500,000. In response, the defendant filed a motion for summary judgment asserting that the alleged preferential transfers cannot be recovered through avoidance powers because they were

(Continued on page 9)

Special points of interest:

- A State in Bankruptcy?
- Contract Assumption Defense
- Selling to Bankrupt Customers
- California Mechanic's Lien Law
- Alter Ego Claims
- timing when asserting the right to setoff

Inside this issue:

Court Warns Vendors of Sales to Bankrupt Debtors

Ronald A. Clifford, Esq.

When selling to a customer that has recently filed for bankruptcy, the main concern becomes securing payment for the goods or services provided. There is always a serious risk of non-payment due to the further erosion of the customer's financial condition while in bankruptcy. This risk can be minimized by simply demanding that the customer pay cash in advance, right? Wrong. In a recent case, In re Delco Oil Co., a court ruled that simply selling to a customer in bankruptcy on cash terms may not shield vendors from a loss on the sale. 599 F.3d 1255 (11th Cir. 2010).

A brief primer on secured creditors and their rights in a bankruptcy case is required to appreciate the ruling of the In re Delco Oil Co. court. Many times when a customer files for bankruptcy, it has one or more secured creditors. Generally, secured creditors are those creditors that have taken a security interests in property of the customer to secure payment of the credit extended, which property is termed the "collateral" securing the loan. Often, as collateral, the customer provides the secured creditor with a security interest in all of the customer's assets, including the customer's cash and accounts. In this instance, the customer's cash on hand, and the cash that enters the estate throughout the bankruptcy, is the bank's collateral. This is termed "cash collateral" in bankruptcy parlance.

To operate its business as a debtor-in-possession in a chapter 11 bankruptcy case, the customer obviously needs the use of its cash. The bankruptcy code requires that the customer either obtain the permission of the secured creditor to use cash collateral, or obtain bankruptcy court approval.

In In re Delco Oil Co., the debtor filed for bankruptcy on October 17, 2006, and filed an emergency motion to use cash collateral on that same date. Unusually, the bankruptcy court did not immediately rule on the motion to use cash collateral. Rather, the bankruptcy court entered an order denying the use of cash collateral on November 6, 2006, twenty (20) days after the bankruptcy petition was filed. Within those twenty (20) days, the debtor paid a vendor of petroleum products more than $1.9 million, which petroleum products the debtor required in the operation of its business. Again, to the vendor, it was simply, innocently and in the ordinary course of business, selling product to a customer for resale.

(Continued on page 8)

Deciphering California's Mechanic's Lien Law

Brooke R. Sanita, Esq.

Mechanic's Lien laws present a valuable tool for those who provide labor or materials for the improvement of real property. Mechanic's Lien laws provide contractors, subcontractors, vendors and materialmen with remedial recourse against non-payment that would be impossible absent such laws.

California's Mechanic's Lien laws have no existence at common law or in equity, they are purely statutory. These laws, which originated as mechanisms to protect a builder from a property owner, have evolved to encompass all who have been directly instrumental in the improvement of the property of others. The mechanic's lien is the only creditors' remedy stemming from constitutional command.

While mechanic's lien laws were originally intended to provide a self remedy to assist the aver-

(Continued on page 10)

Should I Stay Or Should I Go?: Ahcom v. Smeding and the Creditor's Ability to Bypass the Automatic Stay

Johnny White, Esq.

It is a familiar scenario. Your corporate customer has a large, unsecured, past due balance, not backed by a personal guaranty, and has been fending you off with excuses for weeks. At first, it claimed it was disputing certain invoices. Later, the owner confides to your sales manager that his company has cash-flow problems, and needs time to renegotiate his line of credit. Then, though initially professing a willingness to sign a personal guaranty, he fails to deliver promised personal financial statements. Seeing no option, you file suit, obtain a prejudgment writ of attachment and attempt to levy on the company's bank account, at which point it files a chapter 11 bankruptcy, seeking protection from you and its other creditors.

The sequence of collection efforts will vary from case to case, but the bankruptcy filing is the common denominator, and seemingly your customer's trump card. Your weeks, if not months, of maddening efforts to get paid have come to nothing, and now your right to collect has been indefinitely halted by bankruptcy's automatic stay. Unless your debt is secured, you will have little control in the bankruptcy itself, which could last years. During this time the debtor's assets will be eaten up by professionals' fees, resulting in a recovery of pennies on the dollar for you. To add insult to injury, there is a chance that you will be forced to pay back your customer's estate for payments you received within 90 days of the bankruptcy filing.

So, can anything be done to improve your situation?

Although bankruptcy certainly stacks the odds against an unsecured creditor, a recent case from the 9th Circuit federal court of appeals confirms that all hope is not lost, and hands proactive creditors important new leverage in the fight to get paid – the right to sue the owner.

Ahcom v. Smeding, 623 F.3d 1248 (2010) involved a UK-based plaintiff ("Ahcom"), which had contracted with a California corporation – Nuttery Farms – for delivery of product. The product never arrived and, under the terms of the contract, Ahcom proceeded to international arbitration and secured an award. When it sought to have the award recognized and enforced in California, it found that Nuttery Farms had filed for bankruptcy. Undeterred, it then sued the individual owners of the corporation, Henrik and Lettie Smeding for "alter ego" liability.

This was contentious, and carried with it a strong likelihood of failure. Alter ego liability is a theory of legal recovery, under which the "corporate veil," i.e. the notion that corporations have a legal identity separate to their owners, can be "pierced." It holds that Courts

(Continued on page 14)

The Importance of Timing When Asserting the Right to Setoff Against Insolvent Customers

Marisa Commerford, Esq.

Many vendors that sell goods or services to companies often also purchase goods or services from those companies. If you do business with a customer or vendor and you each end up owing the other money, you may have the right to "set off" the amount the other company owes you against the amount you owe it. Are there issues to consider before asserting such rights when you have a customer that appears to be on the brink of bankruptcy? The importance in the timing of asserting the right to setoff when dealing with an insolvent customer is discussed in more depth below.

The Right to Setoff

Section 553 of the Bankruptcy Code preserves the nonbankruptcy right of a "creditor to offset

(Continued on page 12)

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

(Continued from page 1)

unions, several State Governors have mentioned the unmentionable as a possible way of resolving their fiscal woes. Whether such statements are made in earnest or for the purpose of political posturing is difficult to tell.

There is a valid concern in some quarters that the mere *talk* of enacting State bankruptcy legislation could, in and of itself, create a real need for such a scheme by precipitating volatility in the muni-bond market and jeopardizing indispensable relationships between States and their contractors and creditors. This understandable reluctance to discuss the topic should cause creditors to at least consider the possibility that State bankruptcy legislation will be passed with little public forewarning.

"IF A STATE BANKRUPTCY SCHEME WERE ENACTED TOMORROW, IT COULD BE AT LEAST TWO YEARS BEFORE IT HAD ANY EFFECT"

Unfortunately, from a legal perspective, the road to State bankruptcy is paved with nothing but uncertainty. For a start, it is questionable whether the federal government possesses the power to enact a State bankruptcy scheme. At a minimum, if such legislation is enacted, an avalanche of constitutional challenges will be inevitable. At this point it is worth noting that the pending lawsuits challenging the constitutionality of President Obama's healthcare reform were filed in March 2010. Now, almost a year later, the issue has yet to reach a federal court of appeals and, in the final analysis, will almost certainly be resolved by the Supreme Court. When that will happen is anybody's guess. The question also arises whether, if Congress *did* enact a State bankruptcy scheme, the courts would stay the implementation of the legislation pending a determination of its constitutionality. In other words, if a State bankruptcy scheme were enacted tomorrow, it could be at least two years before it had any effect (or, at least, any of the effects intended by its enactment).

The position of State contractors, bondholders, employees, and others is unenviable. Right now, there are probably more questions than answers surrounding the topic. However, it is important to try and maintain a sense of perspective. Many have noted that the problems facing the States – and, indeed, the wider economy – are cyclical rather than cataclysmic. Last Wednesday February 9, at the first of a series of hearings convened by a House Oversight and Government Reform subcommittee to address the problems presented by State and local debt, Iris Lav of the Center on Budget and Policy Priorities noted that historical default rates have been at one-third of one percent since the 1970s and only one State defaulted during the Great Depression (Arkansas). Doomsday predictions are understandable in times like these.

Certainly, at least for now, interested parties would do well to view the state bankruptcy specter from a political rather than legal perspective. Representative Lamar Smith (R-Texas), chairman of House Judiciary Committee, expressed his concerns that "a state bankruptcy option may actually encourage states to borrow more money, knowing that they could later restructure their debt in bankruptcy" and "borrowing would be at higher interest rates for all states because lenders would justifiably charge a price for the risk of state bankruptcy." Such statements, particularly by senior members of the Republican administration which appears to be in the ascendancy on the tedious political pendulum that swings between Democrats and Republicans, should be closely watched as signs of what may be coming.

However, at least for now, common-sense business judgment and risk management are more appropriate than panic, and conducting business with the states probably remains a challenge more suitably addressed by businesspeople than lawyers. That being said, Chapter 9 of the Bankruptcy Code filings by certain municipalities provides some insight into the possible contours of a similar scheme for the States, and how it may impact the trade creditor.

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

THE STATE OF MUNICIPAL DEBTS

The City of Vallejo, California, is one of the few municipalities to actually file Chapter 9 bankruptcy since the financial crisis began. Although Vallejo cut its police force, youth programs, and development plans, it is still struggling to break even. As it prepares to emerge from its two year long bankruptcy, the city must deal with a problem facing many municipalities across the nation: pensions. Currently, both present and future pension liabilities amount to one of the largest problems for municipalities. Nationwide, public pension fund deficits are estimated to be between $1 trillion to nearly $4 trillion, with California alone accounting for an estimated $500 billion. Many states treat pensions as vested rights, and therefore are not subject to unilateral termination or modification. As such, most efforts to decrease or adjust pension obligations outside of Chapter 9 are unsuccessful. The question of how to treat pension liabilities under Chapter 9 has yet to be answered, as municipalities filing for bankruptcy have avoided addressing such politically-charged issues.

Although the pension agreements are valid contracts, the Vallejo bankruptcy judge stated that Vallejo had the authority to void its existing union contracts, in an effort to create a feasible post-bankruptcy work out plan. What are some of the factors that are contributing to the budget shortfalls? Can these factors be considered by the credit professional as factors in measuring credit risk of a municipality and public agency?

In 45 states, taxes and fees are bringing in less than they did a year ago, and 24 states made budget cuts greater than 5%. There is additionally a cumulative state $108.7 billion budget gap projected for 2010. These unsettling statistics raise concerns for the credit professional about risk free credit extensions.

Another factor contributing to many municipal budget gaps is the disparity between state government and private wages and pensions. The state and local government average wage is almost $6 per hour higher than the private sector. The disparity is largely due to the $3.23 state and local governments award their workers in pension and saving plans, compared to 94 cents in the private sector. The government also spends $2 more on health benefits than the private sector.

In addition to the wage disparity, "swap" debts are also contributing to budget crises. Many municipalities took out relatively long term loans with variable interest rates that were expected to stay stable, rather than drastically increase. The creditors and municipalities did not foresee a tumbling economy, and when the market fell, interest rates rose. One of the more dire examples of this type of loan is occurring in Jefferson County, Alabama. The swaps were supposed to make the county's debt more manageable, but instead are forcing it to the brink of bankruptcy – over $4 billion in debt.

Many states, counties, and cities are constructing new ways to raise revenue, without taxing. Multiple cities have started charging large fees for fire and ambulance services rendered at the scene of accidents, though some exempt residents from payment. Multiple localities have also started citing motorists under local ordinances, rather than state vehicle codes, which directs any fine paid to the local government rather than the state. Some states are starting to look into collecting online shopping taxes, a lucrative area that has managed to fly under the radar since its advent. About a dozen states have considered legislation that would require online retailers to collect taxes based on their online sales; however, only a few of these bills have passed.

Although many municipalities are creating clever ways to avoid bankruptcy, a Chapter 9 filing is not a risk vendors can ignore. After a Chapter 9 filing, the debtor commonly reviews its vendor lists to determine which vendors are critical to keep those vendors that provided goods and services necessary to maintain the health and safety of its inhabitants. Those

"MANY STATES TREAT PENSIONS AS VESTED RIGHTS, AND THEREFORE ARE NOT SUBJECT TO UNILATERAL TERMINATION OR MODIFICATION"

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

vendors not found to furnish such critical goods and services may have their agreements terminated or postponed indefinitely.

THE CHAPTER 9 DEBTOR

Chapter 9 of the Bankruptcy Code provides for municipalities to obtain bankruptcy protection, with the primary purpose to permit debt adjustment. The definition of an eligible Chapter 9 debtor encompasses any state-sponsored or state-controlled entity that raises revenues through taxes or user fees to fund public projects. As such, Chapter 9 includes cities, counties, school districts, hospitals, sanitary districts, and port or highway authorities. Chapter 9 is the public sector's equivalent to Chapter 11. A municipality may not be a Chapter 7 or Chapter 11 debtor, nor may an involuntary bankruptcy be commenced against a municipality.

"CHAPTER 9 IS THE PUBLIC SECTOR'S EQUIVALENT TO CHAPTER 11"

A condition for Chapter 9 eligibility is that the municipality be insolvent, based on whether the municipality is generally able to pay its debts as they become due. A basic principle of Chapter 9 is that the municipality continues operations while it reorganizes its affairs and adjusts its debts through a "plan of adjustment." From the viewpoint of a creditor or the bankruptcy court, Chapter 9 is a "hands-off" reorganization, as neither the bankruptcy court nor creditors may interfere with expenditures or revenues generated by the municipality.

TRADE CREDITORS' RIGHTS UNDER CHAPTER 9

In some regards, municipalities enjoy a greater level of protection over their operations and property that non-municipal debtors do not. Chapter 9 recognizes the sovereign power of the states derived from the Tenth Amendment of the Constitution in regards to the management and regulation of daily activities and operations of a municipal debtor. As a result, the bankruptcy court has less power over a municipal debtor than a Chapter 7, 11, or 13 debtor. For example, unlike a non-municipal debtor, a bankruptcy court cannot allow a secured creditor to force a sale of assets to satisfy a lien from a Chapter 9 debtor. Additionally, a municipal debtor does not need bankruptcy court approval to use, sell, or lease its property during the bankruptcy case.

Upon the filing of a Chapter 9, an injunction, or automatic stay, goes into effect enjoining any creditor from taking any action against a municipality's property without first obtaining relief from stay. For trade creditors, the automatic stay enjoins lawsuits to collect on prepetition obligations.

Creditors and creditors' committees' leverage in Chapter 9 is found to be more restricted when compared to Chapters 7, 11 or 13 of the Bankruptcy Code. Chapter 9 provides for the appointment of an official creditors' committee. As with Chapter 11, those creditors holding the seven largest unsecured claims will likely qualify to serve on the committee. However, the powers and duties of a creditors' committee under Chapter 9 are more limited than under Chapter 11.

Under Chapter 11, a creditors' committee has a fiduciary duty to investigate the debtor's financial condition, which requires the committee to consult with the debtor and dig into its business affairs. Moreover, a creditors' committee under Chapter 11 has a duty to assist in the formulation of a plan of reorganization and has standing to request the appointment of a trustee or examiner. On the other hand, under Chapter 9, the municipality has complete control over its operations and a creditors' committee is greatly restricted in its involvement in the administration of the case.

In Chapter 11, the ability of a creditors' committee to seek appointment of a trustee or examiner is one of the most important weapons it holds against untrustworthy or highly incompetent management. However, under Chapter 9, a trustee or examiner may not be appointed as the appointment would interfere with the municipality's political or governmental affairs.

Beyond the restrictions Chapter 9 imposes on

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

the powers and duties of creditors' committees, there may be certain advantages for individual trade creditors under Chapter 9. Many of the risks associated with selling on credit to an account in Chapter 11 may not exist in Chapter 9. For example, in Chapter 11, a debtor that ultimately cannot reorganize may not be able to pay trade creditors in full for goods sold post-petition should the case convert to Chapter 7 liquidation. Likewise, a super-priority creditor, one who lends to the debtor on a secured priority basis, may prevent trade creditors who provide goods or services post-petition from being paid in full.

In contrast, Chapter 9 does not provide for the liquidation of a municipality. Moreover, as the bankruptcy court has no authority over expenditures by the municipality, post-petition operating expenses incurred in favor of trade creditors may not even qualify as an administrative expense. As the court does not supervise what debts the municipality may incur during the case, such claims should not be discharged and should remain liabilities of the municipality after confirmation of a plan.

As with Chapters 7, 11 and 13, those creditors holding unsecured, non-priority claims in a Chapter 9 must file proofs of claims prior to the bar date. Should a trade creditor not timely file proof of its claim, the claim will be disallowed. Preference, fraudulent conveyance and other kinds of pre-bankruptcy transfers are avoidable in Chapter 9. The municipality holds these avoiding powers. Where a municipality refuses to pursue avoidance actions, however, a trustee may be appointed to do so.

The Plan of Adjustment

With Chapter 9, the municipality is the only party who may file a plan to restructure its obligations, referred to as a "plan of adjustment." To permit another entity, such as a creditors' committee, to file a plan of adjustment would interfere with the municipality's right to control its political and governmental affairs. Chapter 9 does not establish a deadline as to when a municipality must file its plan; rather, the bankruptcy court sets the deadline. The bankruptcy court should give a municipality sufficient time to restructure its obligations in setting a "drop-dead" date for the municipality to file its plan. Depending on the complexity of case, this time period could run from perhaps several months to over a year. Should the municipality fail to file its plan by the court-imposed deadline, the court may dismiss the case.

As with Chapter 11, a plan of adjustment is the method by which a municipality discharges its pre-petition obligations and provides the method for repayment of its obligations. Chapter 9 imposes several conditions on a municipality for its plan to be confirmed. Those conditions include the requirements that the amounts paid by the municipality under the plan are "reasonable"; that all post-petition administrative claims be paid in full; and, perhaps most importantly, that the plan is in the best interest of creditors. Prior to any vote on a plan, a municipality must first obtain bankruptcy court approval of its disclosure statement. The purpose of the disclosure statement is to provide creditors with adequate information as to their treatment under a plan. Creditors can agree to any treatment of their claims under a Chapter 9 plan. Trade creditors whose claims are affected by the plan of adjustment have standing to object.

The plan must segregate creditors' claims into classes and describe how such creditor classes are to be treated. The municipality, through the terms of the plan, may offer cash, securities or other property to trade creditors in satisfaction of their claims. A plan of adjustment may be confirmed by consent of the creditors or over the objection of one or more creditor classes. With objection by one or more creditor classes, the cram-down provisions of Chapter 11 apply. A cram-down plan provides for confirmation of a plan notwithstanding its rejection by one or more creditor classes. However, as the nature and purpose of Chapter 9 is to achieve consent between

"MANY OF THE RISKS ASSOCIATED WITH SELLING ON CREDIT TO AN ACCOUNT IN CHAPTER 11 MAY NOT EXIST IN CHAPTER 9"

Chapter 9 Bankruptcies (States Too?) on the Rise? What it Means to the Credit Professional

the municipality and its creditors, the likelihood of a cram-down plan is unlikely. As with Chapter 11, when the municipality's plan is confirmed, trade creditors are bound by the terms of the plan. With the confirmation order, the municipality's debts are restructured and its pre-petition obligations discharged, pending bankruptcy court approval of the securities the municipality will offer pursuant to its plan.

LEARNING FROM CHAPTER 9

For vendors that rely exclusively on a county or city for their business, a Chapter 9 filing can have a dramatic effect, throwing into question their very survival. Even vendors who do not rely directly on county contracts may feel a Chapter 9's rippling effect, as vendors relying on county dollars are unable to pay their suppliers. County and city budget shortfalls raise issues that should cause credit executives throughout the country to re-evaluate the amount of their credit lines to these public agencies, as well as the percentage of their accounts they have with these agencies.

Chapter 9 filings undermine the notion that public agencies always pay their obligations, which notion is often employed by public agencies to justify their demands that vendors accept lower profit margins on their contracts, when compared to contracts in private industry. For those vendors that rely exclusively on public agencies for their business, the threat of Chapter 9 bankruptcy filings may provide the impetus to alter their business mix and move to selling to both public agencies and private industry.

"CHAPTER 9 FILINGS UNDERMINE THE NOTION THAT PUBLIC AGENCIES ALWAYS PAY THEIR OBLIGATIONS"

Scott practices creditors' rights and bankruptcy law. His e-mail is seb@blakeleyllp.com. David is an associate of the New York office and also practices creditors' rights and bankruptcy law.

Court Warns Vendors of Sales to Bankrupt Debtors

(Continued from page 2)

In December of 2006, the debtor's chapter 11 case was converted to a chapter 7 case. The trustee assigned to the chapter 7 case filed a lawsuit against the petroleum vendor for the $1.9 million because those payments were not authorized uses of cash collateral by the debtor. The bankruptcy court agreed. The bankruptcy court took the firm view that should a debtor use cash collateral without the required authorization, those proceeds are recoverable by the estate under a provision of the bankruptcy code that allows the estate to recover unauthorized transfers of estate property. The court was not persuaded by the argument that the petroleum vendor was an "innocent vendor" that was acting in good faith in selling the petroleum products to the debtor. The court ruled that this is akin to a theory of strict liability. Neither the state of mind of the vendor, nor the knowledge of the vendor of the debtor's inability to use the cash collateral is a defense to the unauthorized transfer.

This ruling is becomes problematic for vendors. The financial downturn has landed a record number of companies in bankruptcy. Unless they are creditors of the customer, vendors may not even have notice that the customer has filed for bankruptcy. Ergo, sales to customers may come with an unknown risk. Vendors will need to stay informed on a very regular basis as to the financial health of the customers. Failure to stay apprised of a customer's financial health could prove to be a disaster.

The Final Word on the Contract Assumption Defense to Preference Action

(Continued from page 1)

payments made on an executor contract that the debtor later assumed and assigned. The trustee opposed the motion on three grounds – ambiguity as to the contract assumed, the contract assumption defense does should not be recognized by the court and assuming the court finds that the contract assumption defense is a valid defense, it should not do so in this case because the defendant failed to plead it in its answer.

The trustee asserted that there were two contracts between the debtors and the defendant and assumption motion failed to specify the contract, which the trustee asserted created ambiguity as to whether the payments made by the debtors fell under the assumed contract. The Defendant asserted that, while there were two accounts, the later contract integrated the first contract. The result was that there were two accounts governed by one contract. The court found that the plain language of the the later contract demonstrated that the debtors and defendant intended that it include all provisions of the earlier contract, plus the additional services to be rendered by the defendant. Take away – when more than one contract is in place with a debtor, be sure to demand that the debtor identify the specific contract assumed.

As for the impact of the debtor's assumption of the contract, the fundamental purpose of § 365 is to make the nondebtor contracting party whole upon assumption of the executory contract. Section 365 requires the cure of all outstanding defaults, compensation for damages attributable to the debtor's breach, and adequate assurance of future performance.

The defendant argued that § 365's purpose is directly at odds with a trustee's avoidance power that would permit recovery of the payments made under the assumed contract. Thus, the estate must elect to either assume the contract or exercise its avoidance powers to recover payments under it.

The court found no case squarely on point in the Tenth Circuit, but did recognize that a majority of the courts that have addressed the issue have recognized the contract assumption defense as a complete bar to the trustee's avoidance powers. Many of these courts reasoned that assumption and preference powers are mutually exclusive because they are fundamentally inconsistent. Allowing a preference suit after assumption would undermine Congress' intent that a contracting party is made whole prior to being forced into fully performing.

The court went on to find that the language of § 365(b)(1) is unequivocal. A party to an executory contract must be paid all amounts due him under the contract before the contract may be assumed. In drafting § 365(b)(1), Congress went further than requiring that the trustee guarantee payment for future performance under the contract. It required that the trustee guarantee payment of all amounts owed prior to assumption.

The court went on to find that the debtors' estates had already been enriched by the assumption and assignment of the contract, stating that it would be manifestly unjust to allow the estate to retain the benefit conferred by assumption and assignment, but nevertheless allow the trustee to recover amounts that his predecessor had been required to pay under § 365.

The trustee argued that the hypothetical liquidation described in § 547(b)(5) must be determined as of the petition date, rendering post-petition events irrelevant. He contended that the cases relied on by defendant were erroneously decided because the contract assumption occurred post-petition. The court chose to follow other precedent that found that the contract assumption defense was not predicated on the trustee's ability to meet § 547(b)(5). Take away – the premise that permitting a preference suit after assumption undermines the intent and purpose of § 365 should control and provide a complete defense.

"WHEN MORE THAN ONE CONTRACT IS IN PLACE WITH A DEBTOR, BE SURE TO DEMAND THAT THE DEBTOR IDENTIFY THE SPECIFIC CONTRACT ASSUMED"

The Final Word on the Contract Assumption Defense to Preference Action

The defendant did not specifically plead the contract assumption defense in its answer, and the trustee, in his final argument, asserted that the failure to plead it operated as a waiver of the defense. The contract assumption defense was first asserted in the defendant's discovery responses provided on the discovery cut-off date.

The court found that, unlike other defenses, the assumption of the contract defense rests on a purely legal question and does not require any discovery. Based on this reasoning, the court found this to be a closer call than the trustee's other arguments, but determined that trustee was sufficiently apprised of the defense and suffered little or no prejudice from its later assertion. Take away – even the best crafted arguments can be undermined by an oversight or lack of investigation at the outset of a case.

Deciphering California's Mechanic's Lien Law

(Continued from page 2)

"THE PRELIMINARY 20-DAY NOTICE PROTECTS OWNERS OF REAL PROPERTY FROM SURPRISE CLAIMANTS"

age layman, the reality is that the laws are quite intricate and require strict adherence to the statutory requirements set forth in the California Civil Code.

This article provides a summary of the lien process, including new amendments and common traps to be aware of.

Preliminary Twenty Day Notice

The first step in enforcing a claimant's mechanic's lien rights is to file the Preliminary 20-Day Notice (Private Work). The Preliminary 20-Day Notice protects owners of real property from surprise claimants. The notice must be given no later than 20 days after furnishing labor, service, equipment or materials to the jobsite. However, it is good practice to serve the notice immediately upon starting work.

Among other requirements, the Preliminary 20-day Notice must be served on the owner, construction lender, if nay, and original contractor by either personal or substituted service or by certified or registered mail proved by affidavit. A claimant is not required to record the Preliminary 20-Day Notice recorded with the County Recorder.

According to case law, there may be an exception to the above notice requirement if the owner has "actual knowledge." In a series of cases that include Halspar Inc. v. La Barthe (1965) 238 Cal. App. 2nd 897; Scott, Blake & Wynne v. Summit Ridge Estates Inc. (1967) 251 Cal. App. 2nd 347; and Truestone Inc. v. Simi West Industrial Park II (1984) 163 Cal. App. 3rd 715, California appellate courts have periodically confirmed that, if an owner has "actual knowledge" that work is being done by a particular subcontractor or supplier on his property, that owner may be stopped from raising as a defense that he was never served with a preliminary notice.

Civil Code Section 3129, in summary, provides that if the owner has knowledge of the labor being performed or the materials being furnished, such actual knowledge equates to the owner having requested that labor and materials. Therefore, pursuant to section 3129, the owner effectively possesses the information that would be provided in a preliminary notice and service of such notice would be superfluous. To replace information an owner would gain from a preliminary notice, the knowledge must be actual, as opposed to constructive.

Nevertheless, a claimant is taking a risk with very severe consequences by relying on the above exception if the court does not agree that the owner had actual knowledge of the labor performed or the materials furnished. Therefore, it is always prudent practice to file a timely Preliminary 20-Day Notice.

Mechanic's Lien

The next step in enforcing a claimant's me-

Deciphering California's Mechanic's Lien Law

chanic's lien rights is to record and serve a Notice of Mechanic's Lien and Mechanic's Lien on the owner. The Mechanic's Lien is recorded is done in the County Recorder's office in the county where the project is located. Recording the Mechanic's Lien provides a security interest in the real property and notifies all those who have an interest in the property that it is subject to an encumbrance. The lien relates back to when work on the project first started.

The Mechanic's Lien must set forth: 1) a statement of demand; 2) the name of the owner, or reputed owner; 3) a general statement of what the lien is for; 4) the name of the person who employed the claimant or received the materials; 5) description of the site sufficient for identification; 6) a proof of service affidavit attesting to the service of the owner, reputed owner, construction lender, or original contractor; and 8) a specific notice statement to the owner notifying them that a lien may lead to a foreclosure sale or otherwise encumber the property.

As of January 2011, California law requires that the lien be accompanied by a Notice of Mechanic's Lien verbatim as provided in Civil Code Section 3084 and a proof of service affidavit completed and signed by the person serving the Notice of Mechanic's Lien. If a claimant fails to serve the Notice and Mechanic's Lien consistent with the statutes requirements, its lien will be unenforceable as a matter of law. This harsh result evidences the strict statutory construction required by California lien laws.

There are certain time limits that apply to filing your Notice of Lien and Mechanic's Lien, depending in certain facts. If an owner records a Notice of Completion or Notice of Cessation with respect to the work of improvement, a general contractor must record his lien within 60 days thereafter. If you are a subcontractor, materialman or laborer, the period is only 30 days, provided that the owner serves written notice of the recording on all claimants who served a Preliminary 20 -Day Notice. When the owner fails to record such a notice, all claimants have 90 days from completion of the entire project to record their lien.

Complaint to Foreclose Mechanic's Lien

Finally, the last step in enforcing a claimant's mechanic's lien rights is to file a Complaint to Foreclose Mechanic's Lien. A complaint to foreclose on a mechanic's lien must be filed in the county where the property is located. The complaint must be filed within 90 days of recording the Mechanic's Lien, failure to do so is a bar to maintaining a foreclosure action on the recorded lien.

The Complaint to Foreclose Mechanic's Lien must include: 1) identify the claimant as the plaintiff, setting forth its corporate form and relation to the project; 2) identify each defendant and its corporate form and interest in the property; 3) legal description of the property, including a statement of the land needed for use and occupation; 4) licensure or exemption, if relevant; 5) work performed; 6) performance by claimant; 7) the value of the work or materials; 8) compliance with notice provisions; 9) compliance with procedural requirements; and 9) demand for judgment, including costs of verifying and recording the lien. It is important to note that these are only the minimal requirements to filing an action. A claimant may also want to include additional causes of action such as breach of contraction or unjust enrichment against the general contractor or owner.

Within 20 days of filing the complaint, the claimant must record a Notice of Pendency of Action against the property. The Notice of Pendency of Action must be recorded in the County Recorder's Office in the county where the project is located and should be served on all adverse parties.

As demonstrated above, enforcing mechanic's lien rights under California's laws is anything but simple. Strict adherence to the requirements set forth in the Civil Code is essential to enforce a claimant's rights. Accordingly, it is highly advised for a claimant to seek experienced legal counsel to assist it in ensuring its interests are protected.

"STRICT ADHERENCE TO THE REQUIREMENTS SET FORTH IN THE CIVIL CODE IS ESSENTIAL TO ENFORCE A CLAIMANT'S RIGHTS"

The Importance of Timing When Asserting the Right to Setoff Against Insolvent Customers

(Continued from page 3)

a mutual debt owing by such creditor to the debtor that arose before the commencement of the case...." The requisite elements of a §553 setoff are as follows:

(1) the creditor holds a prepetition claim against the debtor;

(2) the creditor owes a debt to the debtor that also arose prepetition;

(3) the claim and debt are mutual; and

(4) the claim and debt are each valid and enforceable.

Essentially, the right of setoff simply refers to your right to cancel mutual debts with one of your customers. The term is also used to describe a bank's right to set off the amounts owed on a loan against amounts the borrower has on deposit at the bank. In effect, setoff can bump up an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.

"A CREDITOR MAY BE AT RISK TO PAY BACK A SETOFF OCCURRING IN THE 90 DAYS PRECEDING THE BANKRUPTCY"

Two recent cases discussed below highlight the risks associated with the timing of asserting setoff rights, including the risk set out in section 553 of having to pay back a prepetition setoff to the bankruptcy estate under certain conditions.

Risks for the Creditor: Asserting the Right to Setoff Before Customer Files Bankruptcy

Assuming a bankruptcy petition has not yet been filed, and the underlying contract between the parties allows for setoff, a creditor is generally permitted to setoff mutual debts without a formal legal proceeding. However, while section 553 of the Bankruptcy Code preserves the right of a creditor to offset mutual debts with a debtor under applicable state law, it does not necessarily preserve an actual setoff. A creditor may be at risk to pay back a setoff occurring in the 90 days preceding the bankruptcy.

As an illustration, let's say on January 1, Creditor B owes $100k to Creditor A, and Creditor A owes $25k to Creditor B. After Creditor A makes repeated demands for payment on Creditor B's overdue account, Creditor A gives notice to Creditor B that Creditor A has decided to offset the mutual debts, leaving Creditor B with an account balance of $75k owed to Creditor A. On February 1, Creditor B files for bankruptcy. Under what circumstances can the setoff be avoided, and Creditor A forced to pay the bankruptcy estate the setoff amount?

Whether a prepetition setoff can be recovered depends on the "insufficiency" (meaning the amount, if any, by which the debt owed by the debtor exceeds the debt owed to the debtor), which is analyzed under the "improvement-in-position" test.

The improvement-in-position test of § 553(b) provides, in relevant part, that:

(1) ... If a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency [as of] the date of such setoff is less than the insufficiency on the later of –

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

If your position as a creditor was not improved by effectuating a setoff, the debtor has no claim for avoidance in the bankruptcy case. If there has been an improvement in your position, the extent of the improvement is subject to avoidance by the debtor.

Risks for the Creditor: Asserting Setoffs After Bankruptcy

Making a setoff after a bankruptcy is filed, known as a "post-petition" setoff, is allowed only in limited circumstances. In addition to the requirements listed above, the creditor must

The Importance of Timing When Asserting the Right to Setoff Against Insolvent Customers

seek court approval by requesting relief from the automatic stay. If a creditor moves to quickly to offset, the recent decision of In re Lehman Brothers serves as a cautionary tale.

In the Lehman Brothers bankruptcy case, Bank of America had made a post-petition setoff in the amount of $500m a few months after the bankruptcy filing. The setoff funds were in a special cash collateral account set up to protect Bank of America against overdrafts on Lehman's bank accounts. On the petition date, there were no overdrafts. After effecting the setoff, Bank of America then filed an adversary proceeding seeking a determination that the setoff was exempt from the automatic stay.

The bankruptcy court held that the bank had no right to set off funds in the account against unrelated debts, and the setoff violated the automatic stay. The court decided the funds were a special-purpose account, as they were designated solely as security for overdrafts. Under New York common law, funds within a special-purpose account are not subject to setoff (in contrast to funds within a general deposit account that would be subject to setoff). Thus, the bank had violated the stay since the exception from the stay for the exercise of setoff rights did not apply to the account collateral which had no connection to any setoff. Also, the court noted that Bank of America deliberately accomplished the setoff without seeking relief from the stay, a strategy the court described as an:

"…untested, uncertain and extremely aggressive legal position that [the bank] was advancing and the risks [the bank] was thereby assuming that the exception to the automatic stay on which [the bank] relied might be found inapplicable to the seizure of [the Debtors'] collateral."

In contrast, a recent decision of a Delaware bankruptcy court found that a creditor had moved too slowly to offset mutual debts. The court had approved the sale of the debtor's assets several weeks after the petition was filed, which included its accounts receivable to a third party free and clear of all interests in such accounts. A creditor wished to set off its claims against the debtor arising from rejection of its contract to supply goods against an accounts receivable owing by the creditor to the debtor. The court noted that while rejection damages are considered pre-petition obligations and may normally be set off against pre-petition obligations owed by a debtor, it was not enough that the claim was a prepetition claim. The court held that the prepetition claim of setoff must have actually been exercised prepetition, because the sale of the accounts receivable free of "interests" extinguished any setoff claim of the creditor for damages from the debtor's rejection of its contracts.

These cases serve as lessons for creditors that may have setoff claims against insolvent customers. Pre-bankruptcy, a creditor should affect the setoff after a thorough evaluation of potential preference risk under the insufficiency test. Post-bankruptcy, a creditor should be prepared object to any sale of the debtor's assets should the creditor have a setoff right in the assets. The holding from the Lehman Brothers decision serves as a reminder that if a creditor is considering a setoff after the bankruptcy filing, the creditor should always seek approval from the court before taking action.

Bank of America, N.A. v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.), 2010 Bankr. LEXIS 3867 (Bankr. S.D.N.Y. Nov. 16, 2010)

HHI Formtech LLC v. Magna Powertrain USA Inc. (In re Formtech Industries LLC), Adv. Proc. No. 10-50186 (Bankr. D. Del. Nov. 17, 2010).

"THE COURT HELD THAT THE PREPETITION CLAIM OF SETOFF MUST HAVE ACTUALLY BEEN EXERCISED PREPETITION"

Should I Stay Or Should I Go?: Ahcom v. Smeding and the Creditor's Ability to Bypass the Automatic Stay

(Continued from page 3)

should ignore the fiction that a corporation is different from its shareholders, and hold those shareholders individually liable for the corporation's debts, where recognizing their separateness would promote fraud and injustice.

The problem for Ahcom was that, as in many states, it was regular practice in California to forbid individual creditors of a bankrupt entity from bringing such an action while the corporation was in bankruptcy. The received wisdom was that a claim for alter ego liability is a claim that inures to the benefit of all creditors. As such, it should only be brought, if at all, by the bankruptcy trustee, a view endorsed by, among others, a federal appeals court in Georgia (*Bailie Lumber Co., LP v. Thompson*, 413 F.3d 1293 (2005)).

On this basis, the Smedings sought to dismiss the case, and were initially successful. The U.S. District Court for the Northern District of California reasoned that Ahcom was asserting a claim that, if true, harms all creditors, not just Ahcom, and the claim was property of the bankruptcy trustee. It threw out Ahcom's case.

Many would have given up at this point, but either this was personal or Ahcom had a lot riding on it. It appealed, and won. The appellate court reversed, holding that an alter ego claim (under California law at least) involved particularized injuries to creditors, not injury to the body of creditors as a whole, and the claim should only be asserted by individual creditors. Ahcom was entitled to maintain its suit against the Smedings, as could anyone with a viable alter ego claim against a shareholder, even if the company is in bankruptcy.

The implications of this ruling for debt collection and bankruptcy practice in California are profound. The case certainly complicates the calculus of self-interest for owners of closely-held businesses in financial distress.

"THE IMPLICATIONS OF THIS RULING FOR DEBT COLLECTION AND BANKRUPTCY PRACTICE IN CALIFORNIA ARE PROFOUND"

If a bankruptcy filing no longer provides a personal safe harbor for the shareholder, one is left to weigh the incentive of deleveraging your company against the worry that by taking the corporation out of the firing line, you are hanging a target sign on your own back for trigger-happy creditors with little to lose. To the creditor, it just provides another potential pocket for payment.

So what exactly is an alter ego claim?

An alter ego claim may be granted if (1) a unity of interest exists between the shareholder and the corporate entity, and (2) an inequitable result would follow if their separate personalities are recognized. If that sounds vague, it is because it is vague. From the perspective of an unpaid creditor, it is always inequitable to let the owner off the hook when he leaves you high and dry. And unity of interest always exists between corporation and owner. What is a corporation anyway except a legal concept? It has no motivations or desires of its own, and exists only for its owners to make money.

Thus, there is no bright line rule for establishing alter ego liability. Instead California courts have identified more than twenty (20) factors that are indicative, but not conclusive, of alter ego liability. *See e.g. Associated Vendors, Inc. v. Oakland Meat Packing Co.*, 20 Cal.App.2d 825, 26 Cal.Rptr 806 (1962). They include:

(i) undercapitalization of the company;
(ii) failure to run the company separate and apart from personal business interests,
(iii) commingling of funds;
(iv) diversion of assets for personal use;
(v) failure to observe corporate formalities;
(vi) failure to maintain corporate records;
(vii) holding oneself out as being liable for the company's debts.

There are two points to bear in mind about the case-by-case nature of alter ego analysis. First, it is not easy for a creditor to overcome its burden of proof and prevail on the claim. A successful lawsuit may require some lengthy

Should I Stay Or Should I Go?: Ahcom v. Smeding and the Creditor's Ability to Bypass the Automatic Stay

and expensive discovery, and retention of an expert witness to build and prove a case. Ultimately, a judge or jury may be asked to get its head around complicated, inter-corporate machinations that are almost incomprehensible to the lay person. Then, at the end of the trial, confronted with this disorienting morass of information about the corporation's capitalization, formalities and operation, it will need to be sufficiently confident in its knowledge of them to overcome David against Goliath-type emotional appeals.

The second point is that it will often be possible to at least state a colorable claim. Due to the ad hoc nature of the elements of proof, it will be difficult for the individual to show that, under no circumstances could you prove alter ego liability. Cases almost always proceed to discovery, where a creditor will have wide latitude to pry into the company's affairs, and which can be an involved process for the owner and thus a source for more leverage. In addition, the bankruptcy filing has the potential to make discovery more attainable for creditors, who may be able to request the company's books and records from the bankruptcy trustee. The trustee will not have the same incentive as the defendant to withhold damaging information.

Accordingly, *Ahcom v. Smeding* adds an important weapon to the creditor's arsenal. With appropriate facts, the unpaid creditor can use it to apply extreme pressure notwithstanding bankruptcy's automatic stay, and improve its all-round prospects of collection in the process

Finally, though *Ahcom v Smeding* involves alter ego liability, it may have broader implications. The case begs the question of what other pockets for payment a creditor might seek to assert claims against. The holding would heavily circumscribe those causes of action which are property of the bankruptcy estate, and potentially opens the door to other remedies for creditors. One such theory of recovery is successor liability.

Like alter ego liability, successor liability is a form of relief that would hold another entity responsible for a corporation's debts. A typical situation where it comes into play is where your debtor goes into bankruptcy and its owner forms a new corporation the following day. The new corporation operates a similar business from the same location with many of the same assets and customers. Under the theory of successor liability, you would seek to hold the new corporation liable for the bankrupt corporation's debts, because it is a "mere continuation" of your debtor.

Would courts stretch the *Ahcom v. Smeding* holding and apply it to successor liability, or does this fall under the trustee's powers to recover fraudulent transfers? If you have a large balance, are facing a trifling distribution in bankruptcy and have no other options, would it hurt to argue they should?

"LIKE ALTER EGO LIABILITY, SUCCESSOR LIABILITY IS A FORM OF RELIEF THAT WOULD HOLD ANOTHER ENTITY RESPONSIBLE FOR A CORPORATION'S DEBTS"

BLAKELEY & BLAKELEY LLP

2 Park Plaza, Suite 400
Irvine, California
92614

Phone: 949-260-0611
Fax: 949-260-0611
E-mail: info@blakeleyllp.com

The Blakeley & Blakeley Quarterly is published by the law firm of Blakeley & Blakeley LLP and is distributed as a service to clients and other parties interested in creditor issues. This information is not intended to constitute legal advice, nor a substitute for legal advice.

100 Park Avenue, Suite 1600
New York, New York
10017

Phone: 212-984-1033
Fax: 212-880-6499

We're on the web!

www.blakeleyllp.com