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Focus

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Protecting Yourself from Customers in an Economic Downturn

By Victor Bass

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It can be hard enough to run your own business profitably in an economic downturn without worrying about others. However, the most likely way the downturn may affect you is the notification that a customer has filed for bankruptcy, which often means *both* that unpaid invoices will remain unpaid, and that an attempt will be made to recover recent payments as preferences. How can you protect yourself from this troubling and all too common event? This article will highlight some of the issues to be aware of, and suggest strategies to avoid being hurt.

Businesses, like individuals, file bankruptcy for two reasons: to obtain a stay of litigation, foreclosure, or other collection activities and to discharge debts. But even the bankruptcy court cannot discharge what is not owed. A downturn is the time to tighten rather than loosen your credit policies. Know your customers. Obtain credit reports and financial statements. Don't extend credit to customers who are not creditworthy.

C.O.D.

Cash on delivery (C.O.D.) is a common device to avoid extending credit to a customer who isn't creditworthy, and many customers who won't prepay an order will do business C.O.D. Remember, however, that a check is not cash. To be safe from future attack as a preference, certified or bank checks should be used for payment and exchanged with the delivery. Post-dated checks don't avoid the preference problem. They will be deemed a payment on the date the check clears, and thus subject to recovery. Also they'll be worthless if a bankruptcy occurs before they can be deposited.

Secured Creditors

Secured creditors are at least entitled to the "indubitable equivalent" of the value of their property interest, and will be paid in full to the extent of their collateral value. Unsecured creditors, however, often receive pennies on the dollar, or less.

Ask for a security interest. The transaction costs are slight and the protection is substantial. If a general security interest in all property would breach the customer's loan covenants with its bank, get a limited security interest in what you provide, or other specific collateral (e.g. equipment or real estate). A letter of credit from their primary bank lender is better than a security interest, and may be available when a security interest is not.

Guaranties

Ask for a guaranty from the principal(s) of your customer. Of course, in the event of their bankruptcy, you'll come behind their secured creditors, unless you get a security interest from them. But, you'll at least have a second source to which to look, and your customer's principals will have an extra incentive to see that its debts are paid.

Financial Statements

It can be useful to get financial statements from the customer and also any guarantor. They not only provide important information about creditworthiness, but additional leverage if they later prove to have been materially false. A debt for credit extended in reliance on a materially false financial statement is not dischargeable in bankruptcy. In a Chapter 11 case, a questionable financial statement may give you leverage to seek separate classification and more favorable treatment.

Vigilance Can Pay Off

The bankruptcy code protects reclamation rights under the Uniform Commercial Code, which applies in most states. You may get your goods back if you make a demand after learning of the customer's insolvency. It's more likely you'll obtain a priority over other unsecured creditors with respect to claims for all goods received within ten days prior to the demand, or 20 days if the 10th day occurred after the bankruptcy filing. Sellers commonly overlook their reclamation rights or fail to act with the immediacy necessary to preserve them. This is one instance where quick action can make a huge difference.

Do Not Fear Preferences

Some creditors relax their pressure to collect debts when it appears a bankruptcy is imminent. After all, trustees in bankruptcy can recover sums paid up to 90 days before a bankruptcy, can't they?

Not always. For a payment to be recov-

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New Proposed Regulations for Minimum Distributions from Retirement Plans

Evelyn Haralampu is the partner in charge of the employee benefits practice of the Firm. She has extensive experience in advising employers on tax, fiduciary, healthcare and employment law matters related to tax-qualified retirement plans, health and welfare plans, equity-based compensation and executive compensation.

By Evelyn A. Haralampu

The IRS has issued proposed regulations governing minimum distributions from individual retirement accounts (IRAs) and other tax-qualified retirement plans, which greatly simplify the rules on minimum distributions. The most significant change is the use of a simplified distribution schedule for all lifetime distributions. The effect of the new lifetime payout schedule will extend the payout period by reducing each year's minimum required distribution. The annual recalculation of life expectancies has been eliminated as an option for calculating payout periods.

Lifetime Distributions

Minimum distributions must start being paid by an individual's Required Beginning Date (RBD). For IRA owners and employees who own less than 5% of the business sponsoring the retirement plan, the RBD is April 1 of the calendar year following the year in which he/she reaches 70½, or retires, whichever is later. For more than 5% owners, the RBD is the April 1 of the calendar year following the year in which he/she reaches 70½.

The annual minimum distribution due as of the RBD is determined by dividing the account balance by the person's life expectancy factor in the year of distribution. The new schedule for lifetime payouts refers to the participant's age and not the beneficiary's age. One exception is if the participant's spouse is the sole beneficiary and is 10 years younger or more.

Distributions After Death

Distributions required after death will generally be based on the beneficiary's life expectancy. The beneficiary isn't determined until the December 31st of the year *after* the year in which the person died (in this article, this date is called the "Determination Date"). Thus it's no longer necessary, as before, to decide one's beneficiaries at age 70½. Also, beneficiaries who are eliminated (e.g., by disclaimer) before the Determination Date are now disregarded.

Death On or After RBD. If a retirement plan participant (or IRA holder) dies on or after his/her RBD, how payments are made depends on whether the participant has a "designated beneficiary" as of the Determination Date. If so, then the remaining life expectancy of that beneficiary determines the payout period. A "designated beneficiary" means one or more living persons or a qualified trust. If the sole beneficiary is the surviving spouse, (and he/she doesn't roll over the retirement benefits) the payout period is determined using the spouse's birthday. After the spouse's death, the payout period is fixed by using the spouse's remaining life expectancy at death.

If a participant dies on or after the RBD *without* having designated a beneficiary, the participant's remaining life expectancy is used for payouts.

Death Before RBD. If a participant dies before his/her RBD, one of two distribution methods is required. If there is no designated beneficiary, all distributions must be made by the December 31st following the fifth anniversary of the participant's death. "No designated beneficiary" means that either no beneficiary was named at all, or an entity other than an individual or qualified trust (e.g., an estate) was named. If there is a designated beneficiary then distributions may be made over the life expectancy of that beneficiary. If the spouse is the sole designated beneficiary (and does not roll over the benefits), then the distribution may be postponed until the end of the calendar year in which the participant would have reached 70½.

Multiple Beneficiaries

If multiple beneficiaries have been designated for whom no separate accounts (within one plan or IRA) have been established, then the life expectancy of the oldest beneficiary is used to determine the payout period for all beneficiaries. If separate accounts have been established by the Determination Date, however, then separate payout periods are applied for each beneficiary based on his/her life expectancy. It's been suggested that if a beneficiary designation states that beneficiaries are to take from separate accounts (as defined by the regulations) within one plan or IRA, then no physical separation of funds is necessary.

Effective Date

The regulations are proposed to be applicable for distributions beginning on or after January 1, 2002. For calendar year 2001 taxpayers may rely on the proposed regulations or the 1987 regulations. It's not clear under the regulations whether a person dying before 2001 can switch to the proposed system.

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erable as a preference it must have been paid on account of a pre-existing debt while the customer was insolvent. Insolvency isn't a prerequisite to bankruptcy and not all customers who file bankruptcy are actually insolvent.

Moreover, not all preferences are recoverable. Preferential payment claims are subject to several defenses, and they are often compromised for less than the full amount.

This advice isn't always easy to follow. It's hard to press customers for security interests or guaranties while trying to maintain sales volume and margins in unstable economic times. Sometimes you have the leverage to make demands and other times you don't. But focusing on these issues may protect you in some instances and will keep you more aware of the risks you are taking when you extend credit.

Trustees: Don't Get Stuck with the Bill

By Robert J. O'Regan

Robert O'Regan is a partner in our Probate and Trusts and Estates Groups. He has successfully represented clients in matters involving fiduciary duties of corporate officers and directors, trustees, guardians and executors. Mr. O'Regan also represents clients in complex cases in which the valuation and distribution of business or trust assets are a primary issue.

Trustees must pay careful attention and understand the trusts they administer in order to keep themselves from paying for mistakes with their own, personal assets. Trusts afford individuals with an endless variety of options to help manage property. As a tool for estate planning, they enable us to avoid the costs and delays of probate and take advantage of tax-saving techniques. Charitable and family financial management can be accomplished by using trusts. Many people use nominee trusts to hold real estate investments and business trusts for development and other projects. Too often property owners make themselves trustees for the flexibility that a trust allows, and incorrectly believe that the rest of their assets are immune from trust liabilities.

A trustee's personal assets may be at risk because of the legal nature of the position. For all the flexibility that trusts provide, they aren't legal entities. Trusts cannot contract or be sued, own property, or incur obligations. That is because a trustee acts as the legal entity, with fiduciary duties to the beneficiaries that are usually delineated in a written trust instrument. This is unlike a corporation which is created by a formal document filed with the Secretary of State, and has its own legal identity to hold title to property and can be sued. It acts through its officers, who are agents and who may be personally liable for corporate debts as an exception and not the rule.

The general rule in Massachusetts is that a trustee is personally liable for the obligations of a trust. Failure to heed this rule has resulted in creditors' ability to reach trustees' personal assets for significant damages. There are ways to protect your assets against this rule but a trustee should always conduct business on behalf of the trust with this real risk in mind.

First, it is important to pay attention to an often-used technique that may not protect a trustee against personal liability. Frequently, a trustee will sign a document with his name followed by "as trustee and not individually", or similar words. This is intended to limit the assets at risk to trust assets. It is, however, insufficient because a trustee is personally liable for obligations of a trust. A trust doesn't have a legal identity independent from the trustee. Trustees may be held personally liable for large sums even when they've used this language.

The exception to the general rule of a trustee's personal liability requires that the trustee place those with whom he deals on notice that only trust assets are put at risk in the transaction. A starting point is carefully crafted language in the trust instrument, especially for real estate or business trusts. The trustee's limited liability should also be specifically stated in the contract, promissory note, mortgage, or other document with reference to the trust instrument. The reference should be meaningful, and not just an identification of a document that is unavailable to the other party. Several appellate decisions have indicated that merely referring to a declaration of trust, even if it is recorded, may not be sufficient.

The next step is to ensure that the other party accepts the limitation on liability to the trust assets. A clear, simple statement in a document signed by both parties is probably sufficient in most cases. Without such an express acknowledgment by the person with whom the trustee deals, the trustee will avoid personal liability only by proving their mutual understanding. In most situations, a creditor will seek to collect personally from the trustee because trust assets are insufficient and won't cooperate to prove a mutual understanding.

Recent statutory changes have eliminated this problem for trustees of estate-planning vehicles, so that someone dealing with a trust defined by this law may not recover from the trustee personally, under most circumstances. To qualify for this exception, the trust must be a "true trust" in which the donor of property relinquishes many aspects of ownership and control to the trustee that typify nominee, business, and other trusts. Trustees of nominee and business trusts have attempted to stretch this exception when sued for liability under contracts signed "as trustee" without success.

Nominee trusts, often realty trusts holding title to rental or development property, have another hurdle to escape personal liability. In these trusts, the trustees may not take action without the direction of the beneficiaries. The law doesn't recognize the nominee trust as a trust at all, but considers it to be a form of agency. Therefore, it's possible for creditors to reach even the beneficiaries' personal assets to satisfy a trust debt. For nominee trusts, it's especially important for trustees to ensure that anyone with whom they deal agrees to look only to assets of the trust to satisfy a claim.

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Sales of Restricted Stock Under SEC Rule 144

By Ann M. Fox

Ann Fox is a partner in the firm's Corporate Group. She is experienced in various aspects of business and transactional law. Ms. Fox advises privately held and publicly traded companies in general areas of corporate governance and securities regulation, and represents them as buyers and sellers in merger and acquisition transactions.

Recent years have seen an avalanche of initial public offerings. If you acquired stock of a company before it went public and your shares were not registered in the IPO, you are likely the owner of "restricted stock." Restricted stock is generally defined as stock purchased in a private placement transaction directly from a company rather than as a part of a public offering. Restricted stock typically bears a restrictive legend printed on the back of the stock certificate stating that the stock is not registered and cannot be sold or transferred without either registration under the Securities Act of 1933 or a registration exemption.

Unless the Company is about to do a public offering and is willing (or obligated) to include your shares in the offering, the primary route for public sale of restricted stock is the registration exemption provided in SEC Rule 144. If you comply with the requirements of Rule 144, you will be allowed to sell restricted stock in the open market in limited quantities without registering the stock. Rule 144 sales involve a number of steps which can delay a sale, and potentially cause you to lose out on a favorable market price. As soon as you have decided to sell, you should inform your broker that you hold restricted stock so that they can begin the paperwork.

Restricted securities may be sold to the public under Rule 144 without registration if the following conditions are met:

Holding Period

Generally, the stock must have been both paid for and held for a one year period before it can be sold under Rule 144. If the shares were acquired through a purchase, the holding period begins on the date the purchase price was paid in full. If the purchase price was paid by a non-recourse or unsecured promissory note, the holding period begins on the date when the note is paid in full. If you are not an affiliate of the issuer (e.g., an officer, director, ten percent stockholder or a relative thereof), you may be allowed to sell after a two year holding period without compliance with many of the Rule 144 restrictions. In certain circumstances, transferees of restricted stock may be permitted to combine ("tack" on) the holding period of the transferor in order to meet the required holding period. The tacking rules are complex, but they are available in certain gift, dividend and recapitalization transactions.

Current Financial Information

Generally, Rule 144 cannot be used without adequate current information about the issuer being available on the trade date of the stock. Issuers that timely file 10K and 10Q reports with the SEC generally satisfy this requirement.

Notice of Sale

Depending on the number of shares to be sold, a holder of restricted stock must usually file a Form 144 "Notice of Proposed Sale of Securities" with the SEC on or before the date the trade order is placed. The Form 144 will state the number of shares to be sold and the expected date of the sale. The filing is effective for 90 days. If the seller wishes to extend the selling period or sell additional shares, a new Form 144 must be filed.

Volume Limitations

Generally, during a three month period, a seller of restricted stock may sell the greater of: (1) one percent of the class of securities outstanding; or (2) the average weekly trading volume of the class of securities during the four weeks preceding the filing of the Form 144. If a seller is an affiliate of the issuer, the volume limitations may be affected by past sales of non-restricted securities.

Manner of Sale

With certain exceptions, sales of restricted stock must be sold either in brokers' transactions or in transactions directly with a market maker. The seller may not solicit or arrange for the solicitation of orders to buy the stock and may not make any payment in connection with the offer or sale except to the broker who executes the sale.

It is important to remember that Rule 144 is complex, and that certain exceptions or modifications to the above requirements could apply to your situation.

Focus

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