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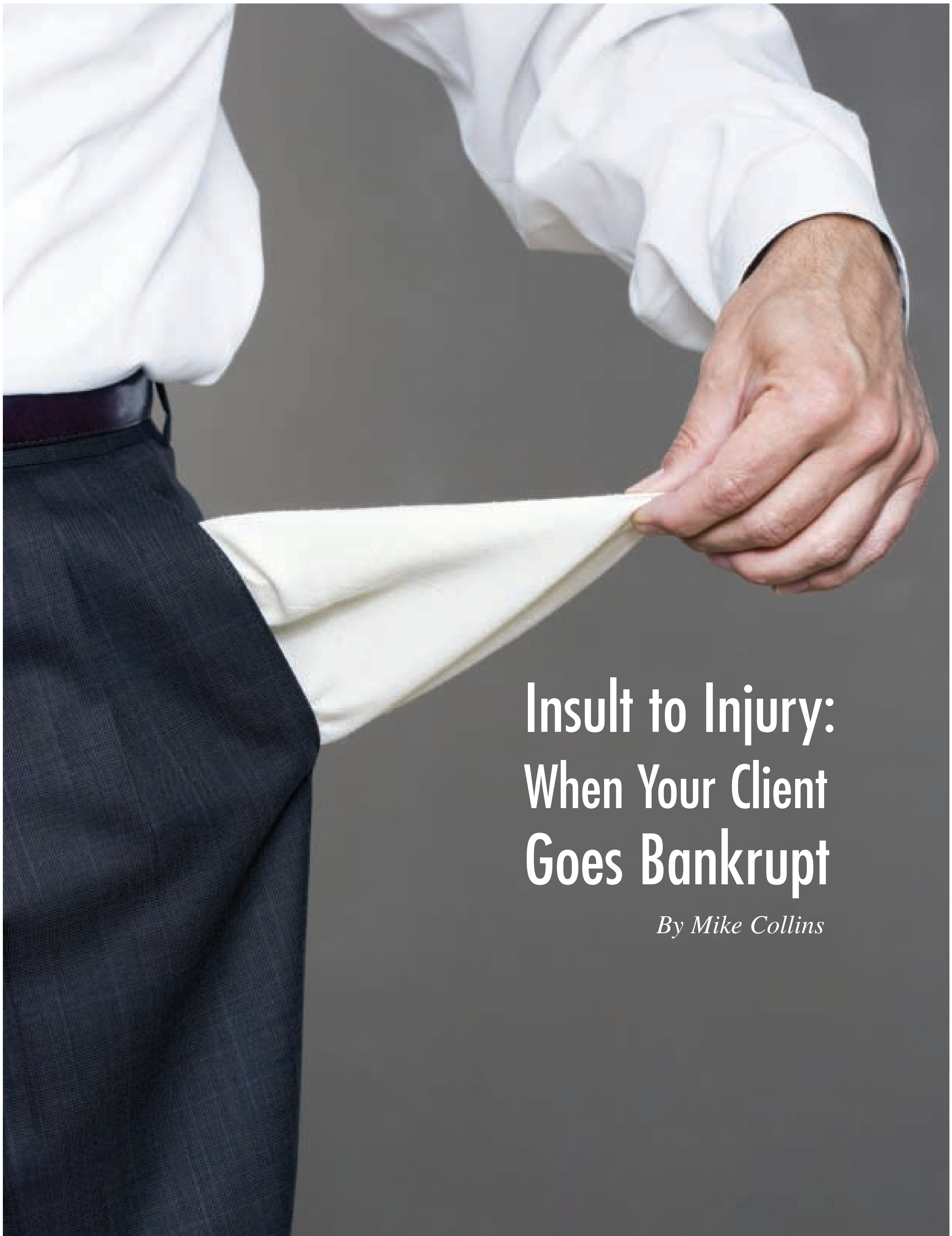

Insult to Injury: When Your Client Goes Bankrupt

By Mike Collins

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The following originally appeared as a two-part series in the Spring and Summer 2007 issues of the CATI Quarterly, *the newsletter of the Carolina Association of Translators and Interpreters (www.catiweb.org). The following is not intended to constitute legal, financial, or other business advice. Each individual or company should make its own independent business decisions and consult its own legal, financial, or other advisors as appropriate. The views expressed here are not necessarily those of ATA or its Board of Directors.*

The corporate world is fraught with traps and pitfalls, and each business owner must decide on a course of action based on the facts on the ground.

When a major client filed for Chapter 11 bankruptcy about two years ago, it came as quite a shock. Not only were some $7,000 of outstanding invoices now protected against collection and unlikely ever to be paid in full, but a stable, long-term, and mutually profitable relationship with a favorite client was suddenly in doubt. All that was bad enough. Then we got the letter….

Bankruptcy is a fact of life in the business world. Companies fail for all sorts of reasons, and the personal and commercial repercussions are often wide-ranging. For suppliers to those companies, the disruption can be difficult or even crippling. Everyone is familiar with the most common issues—unpaid invoices, (potential) loss of an important customer, and uncertainty about the future—but not everyone is aware of one potential nasty surprise.

General Bankruptcy Information

The law provides for several types of bankruptcy. The most common of these are Chapter 7 (liquidation), Chapter 11 (reorganization), and Chapter 13 (debt repayment plan). Chapter 7 provides for the liquidation of assets. This generally means the sale of a debtor's nonexempt property and the distribution of the proceeds to creditors. Under Chapter 7, a court-appointed trustee oversees the liquidation and distribution of the bankrupt party's assets to creditors. Chapter 13 is most often filed by individuals earning regular income, and involves arranging to make partial payment of debts to creditors. Chapter 11, which is what our client chose, is a form of bankruptcy that involves a reorganization of the debtor's business affairs and assets. Chapter 11 is commonly filed for by businesses in financial trouble who need time to restructure their debts.

Declaring Chapter 11

A few well-known things happen when Chapter 11 bankruptcy is declared. The bankruptcy filing date represents a sharp dividing line: any outstanding debts or invoices owed by the declaring company before that date are frozen. It is illegal for creditors to try and collect debts protected under bankruptcy. A trustee is appointed by the court to handle the affairs of the company. The trustee's tasks include examining the records of assets and liabilities, determining how much can be repaid to which creditors, and defining categories of debts (e.g., secured versus unsecured).

Vendors can continue to work for the reorganizing company. Any work performed after the date of filing is handled and paid according to the existing business practices; that is, any payments owed for such work are written on a clean slate, theoretically without fear of non-payment. Indeed, companies that refuse to do business with a reorganizing company just because it has filed for Chapter 11 may be subject to penalties under the law, although enforcement of this stipulation might be difficult in less obvious cases.

When our client declared Chapter 11 bankruptcy in November 2004, we were generally aware of these facts, and learned about other issues in consultation with our attorney. We wrote off (literally and figuratively) the outstanding invoices and continued to work with our client.

The Paper Chase

A steady stream of correspondence began arriving in regard to the filing, including: notices for entry of claims, confirmation of claims, filing deadlines, requests for lists of outstanding debts, ballots for accepting or rejecting the liquidation plan, and court hearing notices. Forms were filled out and signed, information provided, and the fine print duly read. Then we got the letter….

It appeared in the mail like the others on the letterhead of the legal firm handling our client's reorganization/liquidation. At first, it seemed to be just one more formality to wade through. Among the things the letter mentioned were the "Preference

Claim," the 90-day preference period, and the monies received by our client during said preference period. By the time we were finished reading and digesting the letter's contents, we were in utter disbelief, but let me explain a few things first before continuing.

Preference Claims

There are a couple of legal terms associated with bankruptcy I did not mention above, namely "preference" and "voidable preference." Basically, these refer to a situation where one creditor is paid or compensated preferentially at the expense of others during the period before Chapter 11 is declared. Let me explain how this works.

Say Company A is a buyer and Company B is one of Company A's suppliers. Company B becomes aware that Company A may be in financial trouble, and begins to suspect it may declare bankruptcy. Company B knows that if that happens, it may not get paid for work it has done, so it pressures, negotiates, or otherwise "encourages" Company A to pay its debts to Company B ahead of other creditors. If Company B is successful, it may be able to minimize its losses after Company A files for bankruptcy.

To prevent and mitigate such occurrences, the law provides for a "preference period," which is defined as the 90 days prior to the declaration of bankruptcy. "Preference" or "preferential payments" refer to payments made during this 90-day period where the payee was given preferential treatment over other creditors. "Voidable preference" means that where the court/trustee deems such payments were made preferentially, the preference can be voided, and the preferential payments made earlier must be repaid. In our scenario above, if the trustee judges that the payments made to Company B were preferential, it can assert preference and demand repayment of those monies on behalf of (the estate of) Company A. It may now be clear to you where all this is going….

The Preference Defense

The letter we received was a claim on us to repay over $21,000 we had been paid for work done during the 90-day period before our client filed for Chapter 11. The letter went on to say that "applying credits for new value" reduced the amount to around $20,000, and then made an offer to settle for roughly 80%, or $17,000, "…in order to avoid the time and expense of litigation…."

> There may be more at stake than losing outstanding invoices when a client goes bankrupt.

The idea of our small company somehow manipulating this huge client seemed laughable. We had never heard of such a thing, but our lawyer had. He explained the preference concept to us and the standard defense against it, and asked for a record of our invoicing and payments with this client for the past year. If it came to litigation, the burden would be on us to show that: 1) there had been no change in the way we had done business with this company over the past year; and 2) that we had done business in a manner consistent with our industry.

While our attorney was reviewing the material, we received a letter recalling the first one. This second communication stated that the earlier preference claim letter had been sent in error, and apologized for any inconvenience. Our anger dissipated a bit—obviously it had been a mistake, as our attorney confirmed when he said that everything was in order with our payments, and that any case against us would be very weak. We sent a bill with justification for the legal expenses we had incurred to the attorney who had sent us the original preference letter (though we did not really expect a response).

That was in April 2005. Things remained quiet for over a year except for the occasional item of bankruptcy-related correspondence. Then, in June 2006, we received virtually the same letter again, listing what we had been paid during the preference period and offering to settle for 80% of the total, "…to avoid unnecessary litigation…." I contacted the firm and explained that we had already received this letter once before, and that it had been withdrawn as a mistake. The response to me was that just because they had withdrawn it earlier did not mean that they had waived their right to press the claim again.

The Settlement Game

Once again, we turned to our attorney, who brought in a bankruptcy specialist from his firm to help out. We quickly learned that the preference claim, designed to ensure fair distribution of assets during Chapter 11, was very often abused. "I make lots of presentations to business groups on bankruptcy law," said our specialist. "Whenever I get to this topic, the anger

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Suggested links for more information:

U.S. Courts Information Pages on Bankruptcy
www.uscourts.gov/bankruptcycourts/bankruptcybasics.html

Cornell University Law School Legal Information Institute
www.law.cornell.edu/wex/index.php/Bankruptcy

Brief summary of the 2005 changes to Bankruptcy law in regard to preferential payments
www.kkrlaw.com/articles/seller499-1.html
(see under "Preferential Transfers")

in the audience is palpable."

What frequently happens, he explained, is that the trustee or the trustee's law firm will cast a very wide net concerning preference claims. Rather than diligently searching for instances where payments were actually made during the preference period, they simply list most or all of the payees during the 90-day preference period. What follows is then a game of negotiation and settlement designed to bring enormous amounts of cash into the bankruptcy trust, with the law firm usually taking a percentage.

Preference claims are tried in federal court before a bankruptcy judge. A typical defense would consist of producing records showing that there had been no deviation from the ordinary course of business during the 90-day period, and hiring an expert witness to testify that the terms of business between the client and the vendor were normal for the industry in question. Up until 2005, any litigation over preference claims had to be done in the jurisdiction of the trustee. The law has since been amended to change this to the jurisdiction of the litigee, and to bar preference claims for amounts under $5,000. However, our client's bankruptcy had been filed before the law was amended, and we faced the prospect of being forced to defend any litigation in a court in Tennessee, instead of our home state of North Carolina. This would add additional costs to our defense, including hiring counsel out of state.

Widespread abuse of the type we experienced was one of the reasons for the 2005 amendment. Federal bankruptcy judges were well aware of these abuses, and that could be a point in our favor in our case, which is still ongoing. As for punishing the abusers, the only option is to file post-trial motions to investigate whether the determination of preferential payments was proper. If it was not, the trustee and/or lawyers can be sanctioned.

The Creditor's Net

In the case of our client, there were a few unusual circumstances that seemed to support our supposition that this was not a simple preference claim, but rather a gold-digging expedition. When the company filed for Chapter 11, its largest creditor moved in to purchase the bankrupt company and began liquidating it. We knew this creditor was owed millions of dollars and stood to receive (like the rest of us) only pennies on the dollar in repayment. Anything the creditor could do to enrich the estate before distribution would increase its total recovery in the end. Once the wide net was cast, many businesses would likely settle to avoid the headache and expense of litigation.

Our attorneys reasserted our position that the payments we had received were not "voidable" (could not be claimed as having been paid preferentially). We included a detailed list of invoice dates, check-received dates, and other information as justification.

The response from the trustee's attorney was an offer to settle for $6,750, considerably less than the original proposal. This indicated to us that he had reviewed our documents and was aware that his case was very weak. Our attorney confirmed our assumptions, and added that this amount was roughly equal to what we would probably have to pay to defend ourselves. In other words, the trustee's attorney was gambling that we would do the numbers and pay protection rather than risk a lawsuit.

High Stakes

We had arrived at the moment of decision: should we settle or fight? We consulted with our attorneys at length. While we had the strongest defense they had seen in such a case, one can never be sure what will happen in court. Although it was clear that the trustee knew his case was weak, if we failed to settle and then somehow lost in court, we would be liable for the entire $21,000 of the original preference claim. "In addition, the trustee has nothing to lose," the bankruptcy specialist told us. "They can hand these cases off to be tried on a contingency basis, so that they incur no expenses, and the litigating attorneys are paid only if they win."

With these stakes in mind, and one day to think about it, my two partners and I considered what to do. We knew that the easy thing to do was to settle (i.e., pay them to make them go away). After all, the settlement they were offering was considerably less than what they had originally demanded. What if we went to court and lost? The hit to us would be substantial.

In the end, we decided to fight. From the cold perspective of the balance sheet, this may not have been the best decision. However, in our minds there was more at work here than dollars and cents. There was a principle at stake—the principle of not giving in to what, in our eyes, amounted to extortion. There was also the principle of our belief in the system. We knew we had not been paid preferentially, and, therefore, there could be no evidence of it. Our attorneys had informed us well on the possibilities and options. We had to believe that the court would look objectively at the evidence and rule in our favor. Lastly, we felt that if we were going to have to spend some $6,000 anyway, we would prefer to give it to someone for defending us against a wrong, rather than reward the trustee's bad behavior.

Our attorney sent the trustee's attorney a curt response rejecting their offer, and suggesting they prepare themselves for our post-trial motions. We have heard nothing since, but that does not mean we are out of the woods.

Stay Informed

I hope that presenting our case here will help inform and prepare my business colleagues should they ever face a similar eventuality. In no way do I want to suggest, however, that our final decision and course of action is the best or the right one for anyone else. The corporate world is fraught with traps and pitfalls, and each business owner must decide what to do in such a situation based on the facts on the ground.

However, I do believe that there are many things in our business environment that encourage us to settle too easily in cases like these. The end result has probably been wider abuse of the law. It is my hope that the 2005 amendment to the bankruptcy law will reduce the number of such cases of abuse, but they will most certainly not be going away. In any case, it is important to be aware that there may be more at stake than losing outstanding invoices when a client goes bankrupt.

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