SAN FRANCISCO

Daily Journal

www.dailyjournal.com

WEDNESDAY, SEPTEMBER 14, 2011

LAW FIRM BUSINESS

Avoiding avoidance: Keeping payments after client bankruptcy

By William Faulkner and Tyler Atkinson

Imagine you work hard for a corporate client, and get a great result. A month later, the client declares bankruptcy. Fortunately, all of your invoices have been paid up. Too bad for the client, but you're in the clear, right?

Wrong. If a client declares bankruptcy, you may be sued for the return of fee payments. This can happen even if at the time you performed work, you were unaware of your client's financial trouble. It does not even matter if the payments were compensation — even modest compensation — for particularly valuable work.

The purpose of the preference action is to impose fairness on how debts are paid with limited funds, and to discourage creditors from hastening collection efforts against struggling debtors.

The "preference action" is a suit by a trustee or debtor-in-possession to recover payments made to a creditor shortly before bankruptcy. It is a mechanism that allows the trustee to "avoid" or "set aside" certain transactions made prior to bankruptcy, an act often referred to as "an avoidance." To qualify as a preference transfer, a payment needs to fall under the conditions set forth in 11 U.S.C. Section 547(b). The payment needs to have been for the benefit of a creditor (e.g. a law firm) for the payment of antecedent debt (e.g. services rendered). The payment must be made within a pre-bankruptcy window, typically 90 days before the bankruptcy filing. The debtor needs to have been insolvent at the time of the transaction. (However, there is a statutory presumption that the debtor was, in fact, insolvent during the 90 days before bankruptcy.)

The criteria of Section 547(b) are threshold elements; if the elements are not met, the payment is not a preferential transfer. Note that a payment of a retainer is not for antecedent debt. A retainer may nevertheless be set aside, not as a preference payment, but as a fraudulent transfer under state or federal law. Furthermore, depending on the nature of the retainer agreement, payments out of a retainer to pay for services rendered may qualify as payment of antecedent debt.

The purpose of the preference action is to impose fairness on how debts are paid with limited funds, and to discourage creditors from hastening collection efforts against struggling debtors. The action allows the trustee to set aside transfers that the law deems unfair. As a company fizzles toward bankruptcy, one creditor cannot receive preferential treatment while another stands by, holding the bag. Using the preference action, payments to the benefit of one creditor may be "clawed back," absorbed into the estate, and disbursed evenly among all creditors. The rule is merciless in that no special preference or favoritism needs to be shown. Rather, if you were paid and another creditor wasn't, then the payment, unless it falls into a protected category, is vulnerable to avoidance.

Fortunately for a creditor who received payments before bankruptcy, there are a variety of transfers protected under 11 U.S.C. Section 547(c). As a preliminary matter, pursuant to Section 547(c)(9), if the total amount paid to a creditor during the pre-bankruptcy window does not add up to $5,850, the payments are not reversible.

For a lawyer, another potentially useful exception is Section 547(c)(4). Where a creditor has provided "new value" *after* a transfer, the transfer cannot be clawed back. Under the statute, "new value" means, among other things, "money or money's worth in goods, services, or new credit... but does not include an obligation substituted for an existing obligation." Thus, where an attorney has provided billable services after the alleged preferential transfer, the transfer can at least be shielded in an amount equal to the value of those services.

Perhaps the most relevant exception is Section 574(c)(2), which prevents a trustee from reversing a transfer to pay debt incurred in the "ordinary course of business or financial affairs" where the payment of the debt was either also made in the ordinary course or where it was made according to "ordinary business terms." Where a considerable sum is at stake, this provision is fertile ground for explanation, argument, and disagreement. Any sudden increases in bills and payments during the pre-bankruptcy window may receive great scrutiny over whether they were for debts made in the ordinary course and were paid in the ordinary course, or paid according to industry standards. (See Business and Professions Code Sections 6146-6149.5 and California Rule of Professional Conduct 4-200, which govern attorney billing requirements.)

In the event that a client declares bankruptcy and you receive a clawback demand from a trustee, consider any settlement offer and the strengths of your case. One or more of the Section 547(c) exceptions may apply to the transfers at issue. Make a timely response to the demand, marshalling evidence that the payments were in the ordinary course of business and, if applicable, that there were subsequent advances of new value within the 90-day period (i.e., billable work performed during the period and after the alleged preferential transfer). Of course consider consulting a bankruptcy lawyer to help decide how to respond to the demand.

Even before any clients declare bankruptcy, there are steps a firm can take to help avert clawback, or at least minimize the risk of a large claim. First, make sure bills are paid on time, even from clients with whom you have a good relationship. Regular billing cycles are evidence of an ordinary course of business or financial affairs. Moreover, the less that is owed and then paid at any given time, the less there may be to scrutinize. Second, if a client is in arrears, follow normal protocols to try to make sure the client pays and avoid unusual measures. Third, if you are concerned about a client's financial situation, keep an eye on public information about the client's financial condition. If bankruptcy appears imminent, if possible, arrange for payment from another source. (But keep in mind California Rule of Professional Conduct 3-310(F), concerning the requirement to avoid representation of adverse interests.)

Ultimately, bankruptcy is a part of American business. More than 50,000 companies declared bankruptcy last year. If a client files for bankruptcy, you can expect scrutiny of pre-filing payments. If scrutiny leads to a clawback demand, you should carefully consider your options. You may be able to avoid an avoidance.

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