PROFESSIONALS: DON'T KNUCKLE UNDER WHEN A TRUSTEE WANTS TO CLAW BACK YOUR FEES

By Joe Kingma and John Bunyan*

The landscape is littered with bankrupt clients and those who may be about to become bankrupt. These are dangerous clients who pose special risks for professionals, especially lawyers and accountants. However, you do not want to abandon a client just because they may have been mortally wounded. Thus, many professionals end up doing work for clients who ultimately become insolvent.

Professionals with failing clients must keep in mind:

(1) You don't want to facilitate or participate in any fraudulent conveyances;

(2) You may not get paid for your work; and

(3) Your litigation risk is growing dramatically and you may want to terminate your engagement to avoid further risk.

Often, professionals actually are paid at least some of what they are owed shortly before a bankruptcy filing. Once a bankruptcy is filed, you face an unusual decision tree. If you are owed money, you have to decide whether or not to file a proof of claim in the bankruptcy court. The debtor's schedule of liabilities and assets is often available online and you may be able to evaluate your chances of recovery while sitting at your desk. Filing a proof of claim may have the effect of ensuring that any malpractice claims brought against you will be brought in the bankruptcy court and not in a state or federal district court. Many defense lawyers would tell you that you are better of in a "regular" court than a bankruptcy court if you are defending malpractice claims. This is obviously a consideration you should take up with your lawyer. You need to evaluate your claim for fees, as well as your risk for a malpractice claim.

Even if you decide not to pursue recovery of unpaid fees, and even if no malpractice claim is brought by the trustee, you are not yet out of the woods. Trustees must recover assets of the debtor to repay creditors, and many are very aggressive in their attempts to do so. Professionals, and others who have been paid by the debtor prior to bankruptcy, need to be concerned about actions claiming that:

(1) Payment to the professional was an avoidable preference; or

(2) Payment to the professional constituted a fraudulent transfer.

AVOIDABLE PREFERENCES

The rule against preferential payments is intended to keep debtors on the verge of bankruptcy from paying off favored creditors at the expense of other, usually unsecured, creditors. The trustee's burden of proving that a payment to a professional was an avoidable preference[1] requires a showing that:

(1) The payment was made to or for the benefit of the professional;

(2) The payment was made on account of a previous debt;

(3) The payment was made while the debtor was insolvent;

(4) The payment was made within 90 days of the filing of the bankruptcy petition (or within one year if the creditor was an insider); and

(5) The payment allowed the professional to receive more than he would have if the debtor's estate was liquidated in Chapter 7 bankruptcy.[2]

The trustee does not have to prove the specific date when the debtor became insolvent because the debtor is presumed to be insolvent for the 90 days preceding the filing of a bankruptcy petition.[3] This allows a trustee to make a broad claim that any payment from a debtor to a professional for services made in the 90 days before a bankruptcy petition is filed was a preference payment that belongs to the bankruptcy estate.

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1 11 U.S.C. § 547(g).

2 *Id*. § 547(b); *In re Globe Mfg. Corp*., 567 F.3d 1291, 1296 (11th Cir. 2009).

3 11 U.S.C. § 547(f).

If the trustee makes this initial showing, he does not automatically recover the payments. The burden then shifts to the professional to prove that the payments were not avoidable preferences. The most common defense for professionals who are trying to keep payments for services provided is to show that either:

The payment was made in the ordinary course of business; or

The payment was made according to ordinary business terms.

The "ordinary course of business" defense requires the professional to show that the alleged preference payments were no different than other payments received from the debtor.[4] This is easier to show when the parties have an extensive history of dealing with each other. For example, imagine that the debtor and professional had been doing business with each other for 10 years and that the debtor paid every invoice from the professional within 30 days. If the debtor similarly made the alleged preferential payments within 30 days, then the professional has a strong defense that these payments were made in the ordinary course of business. But if the debtor waited 90 days to make these alleged preferential payments, then this argument is much tougher to make.[5] As the Eleventh Circuit has explained, "[a] creditor who tolerates unusual delays in payment from a debtor on the verge of bankruptcy may be dependent on the debtor and aiding the debtor in forestalling the inevitable to the detriment of less dependent creditors."[6]

The "ordinary course of business" defense can be used even where the parties do not have an extensive history of transactions together. The parties' engagement agreement is the best evidence of what they intended an ordinary transaction to be.[7] So if a professional can show that the parties agreed that invoices would be paid within 30 days and the alleged preferential payments complied with this agreement, then the professional may still prevail on the "ordinary course of business" defense.

The other common defense for a professional is to show that the payments were made according to "ordinary business terms." For this defense, the professional must show that its transactions with the debtor were consistent with the way things are done in the industry.[8] Instead of focusing exclusively on the history of dealings between the parties, this defense requires specific, objective data on payment practices in the industry.[9] This often results in a battle of the experts on industry standards that creates a question of fact for the bankruptcy court to decide.

FRAUDULENT TRANSFERS

If a trustee cannot show that a payment to a professional was an avoidable preference, it can also claim that a payment or debt is avoidable as fraudulent. Payments made or debts incurred within two years of filing for bankruptcy may be recovered by the Estate as fraudulent.[10]

There are two ways for a trustee to make this claim. He can argue that the debtor made the payment or incurred the debt with an actual intent to defraud its creditors.[11] This type of claim can succeed only where the trustee has evidence of a fraudulent intent. In most situations, it is unlikely that the trustee will have this "smoking gun."

Professionals are more likely to face a claim of "constructive" fraud, which means that a payment made or debt incurred is assumed to be fraudulent under certain circumstances.[12] A payment to a professional can be constructively fraudulent if the debtor is, or is about to be, insolvent and the value the debtor received in the exchange is too low.[13]

This burden is not quite as easy for a trustee to meet as the initial burden for preferences. There is no presumption that a debtor was insolvent for a certain time period for a fraudulent payment claim, so the trustee must actually show that the debtor paid after the debtor became insolvent. Also, the trustee must show that the debtor did not get its money's worth out of the transaction. This may be easy if the debtor paid an

4 *In re Globe Mfg. Corp*., 567 F.3d at 1298.

5 *Id*. ("[U]ntimely payments are more likely to be considered outside the ordinary course of business and avoidable as preferences." (quoting *In re Craig Oil*, 785 F.2d 1563, 1567-68 (11th Cir. 1986)) (alteration in original)).

6 *In re Issac Leaseco, Inc*., 389 F.3d 1205, 1212 (11th Cir. 2004).

7 *In re Globe Mfg. Corp*., 567 F.3d at 1298.

8 *Id*.; *In re Issac Leaseco, Inc*., 389 F.3d at 1210.

9 *In re Globe Mfg. Corp*., 567 F.3d at 1298.

10 11 U.S.C. § 548(a).

11 *Id*. § 548(a)(1)(A).

12 *In re Chase & Sanborn Corp*., 813 F.2d 1177, 1180 n.2 (11th Cir. 1987).

13 11 U.S.C. § 548(B).

accountant $50,000 to print a tax document from the IRS's website and mail it to him. While most transactions are not so obviously fraudulent, a trustee often can present enough evidence on this ground to create a question of fact that will survive summary judgment.[14]

If the trustee can show insolvency and inadequate value, the professional has the burden of showing that a payment received or debt owed is not fraudulent. The most common defense is that the professional (1) received the payment or obligation to pay, (2) for value and in good faith, and (3) in exchange for value it gave to the debtor. Again, this defense centers around the question of "value." For purposes of these types of fraud claims, "value" means property or satisfaction of a present or existing debt of the debtor.[15] In simple terms, a professional should be able to succeed in defeating a fraudulent transfer claim if he received the payment in exchange for services provided to the debtor at a reasonable price. Professionals should try to show a lengthy history of similar payments for similar services before the debtor became insolvent. They might also show similar charges to other clients who were not insolvent.

CONCLUSION

Professionals must be wary of clients in failing financial circumstances. Once a client goes into bankruptcy, you are unlikely to receive payments for fees that were owed at the time the Petition was filed. That does not mean, however, that you must give in to a trustee who would like to assert claims for avoidable preference or fraudulent transfer. Just because a trustee asserts the claim does not mean that he or she will prevail. Particularly if the amount of fees sought in the claw back is substantial, you should consider fighting back to protect the fees that you have earned.

[14] *In re Chase & Sanborn Corp*., 904 F.2d 588, 593 (11th Cir. 1990).
[15] 11 U.S.C. § 548(d)(2)(A).

TOXIC CLIENTS...

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demand an unwarranted amount of attention. Further, she can cause financial problems for you and your firm by refusing to pay bills or by presenting a looming threat of a legal malpractice action. Although malpractice claims appear to be statistically unavoidable,[2] increased legal malpractice claims lead to higher insurance premiums, which impinge on the firm's financial success, reputation, and overall well being.

We focus below on how to identify and avoid a toxic client before it is too late, and how an attorney can extricate herself from difficult situations with an existing toxic client when problems arise after a relationship has been formed. Handling these delicate issues with finesse and caution may avoid future litigation with the toxic client related to collection of fees and legal malpractice claims.

RED FLAGS HELP IDENTIFY A TOXIC CLIENT BEFORE RETENTION

Toxic clients tend to have several common characteristics, which immediately should present as "red flags" to an attorney engaged in the pre-client screening process. "Red flags" include a potential client who: (1) is a professional litigant; (2) has a demonstrated history of problems with attorneys; (3) is coming to you presenting an imminent deadline or an immediate emergency; (4) plays on your sympathies; (5) comes to you with unrealistic expectations; (6) is being controlled by a third party; (7) acknowledges the existence of a disadvantageous factual or legal position but professes not to care; (8) skimps on legal research, motion practice or important tasks in a quest to save money; (9) won't listen to professional advice when it is given; (10) demonstrates a pattern of refusing to take responsibility for his or her previous decisions; and (11) wants to engage in multiple representation. Another significant red flag is the client who immediately engages the attorney in a dispute over the terms of the representation, such as a retainer to be paid or the hourly fee to be charged.

In order to effectively identify these potentially dangerous and demanding clients, it is important to have effective screening prior to accepting the representation in question. The initial interview is extremely valuable and should not be overlooked or minimized. It needs to be handled by an attorney, and it should be in person. The potential client should be asked to bring all pertinent documents related to her case, and if she was formerly represented by a different attorney, you should

[2] On average, an attorney is sued for legal malpractice approximately three times during his or her legal career. James M. Fischer, *External Control over the American Bar*, 19 Geo. J. Legal Ethics 59 (Winter 2006).