High Tech Counsel Corner

Among the more frustrating tasks for a business attorney is helping a client deal with a bankrupt customer. For the client company, it feels like Alice going through the Looking Glass. The rules are complex and arcane, and the outcome often defies common sense. Worse yet, being subject to a claim of having received a preferential payment from your customer adds insult to injury – and, if you lose, injury to injury!

A typical case is a company that is owed money by a customer who has filed for bankruptcy. At one level, the company understands that a customer's bankruptcy is a risk of doing business, and the company usually files a proof of claim for the amount due - hoping to recover at least some of the money owed.

The rub may come later (and it could be well over a year) if the company owed money ends up being sued for the repayment of a "preferential transfer". In that case, the creditor company becomes the defendant in a lawsuit seeking the repayment of amounts paid by the bankrupt customer. So now the non-bankrupt company is not only left with a large receivable, but may have to pay back monies that it received prior to the bankruptcy filing. At this point the company's CEO is just shaking his or her head in disbelief.

We are seeing more of these so-called "preference claims" being filed en mass in large bankruptcy cases. Law firms may take these cases on contingency and file claims against every vendor who received a payment in the 90 day (sometimes one year) look-back period prior to bankruptcy. Often no investigation is done to determine whether such payments were permissible under the bankruptcy rules. The creditor company (and now defendant) then must defend itself and show that the payments it received are allowed.

The potential of being subject to a preference claim puts a client company in a very difficult position. Its financially troubled customer may be a long standing and valued customer. The financial troubles may develop slowly over time, and the client company may not want to act precipitously in denying products or services.

There are ways to structure transactions with financially troubled customers that can help in defending against a subsequent preference claim. When you first learn of a customer's financial troubles, we suggest that you consult a knowledgeable attorney about ways to structure future dealings with the customer and to minimize the risk of an adverse result if a bankruptcy preference claim is later filed.

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