

# Bankruptcy-related litigation

Protecting secured and unsecured creditors from financial loss **Interviewed by Leslie Stevens-Huffman**

**W**hen a major customer files for bankruptcy, you may think that the receivables you have already collected are safe in the bank. That is, until you are confronted by a demand letter and ensuing litigation from counsel for a trustee, debtor in possession or unsecured creditors' committee seeking repayment of all transfers received from your customer within the 90 days prior to the bankruptcy petition date known as the "preference period." Your business is then faced with the prospect of not only having to disgorge what was received but also with the costs of defending the claim.

"While it is important for CEOs to act decisively once such a claim is made, because of prior inattention to the receivable, many times it is simply too late to significantly alter the outcome," says Jeffrey Isaacs, a partner within the Finance, Restructuring & Bankruptcy practice at Procopio, Cory, Hargreaves & Savitch LLP.

*Smart Business* spoke with Isaacs about how CEOs should handle adversary proceedings in bankruptcy court and some of the proactive measures that are helpful in defending bankruptcy-related litigation.

## What are bankruptcy avoidance powers?

As a CEO, you may not be aware that some of the companies you are dealing with are on the verge of bankruptcy and, should they file, you may be subject to litigation based on what are known as 'the trustee's avoiding powers.' Avoiding powers are statutory rights provided to a bankruptcy trustee or debtor in possession in a Chapter 11 case to recover certain transfers of property such as preferences, transfers in fraud of creditors or avoidance of certain liens created before the commencement of a bankruptcy case.

Even if your debt is secured by a lien, it may be divided into a secured claim, to the extent of the value of the collateral, and an unsecured claim equal to the remainder of the total pre-petition debt. Generally, a secured claim must be perfected under applicable state law to be treated as a secured claim. In this regard, a perfection problem that is corrected at the eleventh hour is often treated as an avoidable preference.



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## What are adversary proceedings in bankruptcy court?

Bankruptcy litigation, known as 'adversary proceedings,' is litigation conducted pursuant to the specific Federal Rules of Bankruptcy Procedure. One unique feature of the litigation is that personal jurisdiction may be easily acquired through service by mail. Usually, bankruptcy adversary proceedings will be commenced in the district where the underlying bankruptcy case is pending, which may have no relationship to where the facts giving rise to the claim occurred and is therefore convenient only to the trustee or debtor in possession and its counsel.

Because of this, from a pure tactical standpoint, the deck is decidedly stacked in favor of the trustee or debtor in possession. Also, fees for prosecuting the preference action are normally borne by the bankruptcy estate, whereas fees in defending a preference action are borne solely by the creditor alleged to have received the avoidable transfer.

## What immediate steps should CEOs take if their company is sued?

Because there is normally only 30 days to respond to an avoidance action once it is

filed, it is important for the CEO to act decisively and receive advice as to whatever options are available in defending the action, such as abstention or change of venue.

## Do CEOs need local or specialized representation?

If you end up defending the action in a distant jurisdiction, it's often important to hire local counsel because the judges and attorneys who work bankruptcy cases in a given judicial district tend to have very collegial relationships, so this will level the playing field to some extent. However, the creditor's general counsel may also participate on a pro hac vice basis to avoid duplication of effort and reduce defense costs.

## How can CEOs evaluate the costs of defense in determining their options?

Since your company will be responsible for the costs of defense in any event, it is important to weigh the projected expenses of defense and the potential outcome. CEOs do not want to find themselves in a position where the already incurred cost of defense becomes the primary factor in whether the litigation should go forward. Experienced bankruptcy counsel can provide realistic estimates that can help with this risk/benefit analysis at an early stage in the case.

## What proactive steps can be taken to ensure success in bankruptcy-related litigation?

It is important to monitor how your customers are performing in regard to payment of your accounts receivable and how much credit you are extending to them. If it appears that a customer is having financial difficulty and is falling behind in payment, decisions as to how any monies received against those receivables is applied may be vital to the ability to defend a subsequent preference claim.

Since we may be headed toward an economic downturn, it's likely that these issues will arise in greater frequency.

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