


Legal Remedies for Delinquent Customers



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THE LEGAL OPTION MATRIX

The legal options available to a creditor that has been the victim of a customer delinquency will vary, depending on the particular facts and circumstances, including how the creditor positioned itself prior to the delinquency:

- Does the creditor have security interests?
- Is the creditor holding personal or corporate guaranties?
- Does the creditor have evidence of fraud? Insolvency?
- Are there other similarly-affected creditors of the customer?

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LEGAL REMEDIES FOR DELINQUENT CUSTOMERS

Presented to:
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THE LEGAL OPTION MATRIX

Scenario	Primary Option	Secondary/Concurrent Option
Customer fails to timely pay under invoice or existing supply agreement	State/federal lawsuit for breach of contract / unjust enrichment	State/federal lawsuit for breach of contract / unjust enrichment
Creditor holds security interest in customer's assets	State/federal lawsuit for foreclosure	
Creditor holds guaranty of customer's obligations	State/federal lawsuit for enforcement of guaranty	Involuntary bankruptcy filing
Creditor was defrauded by customer / its principals	State/federal lawsuit for common law fraud / fraudulent transfer	

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THE LEGAL OPTION MATRIX

- It is important to note that the remedies on the previous slide are *not* mutually exclusive.
- So for example, if you have both a personal guaranty and a security interest, you have the option of seeking concurrent relief on both the guaranty and the security interest.

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BREACH OF CONTRACT / UNJUST ENRICHMENT

- The most common claim based on a customer's failure to timely pay invoices or under a supply agreement
- Assuming that a valid and enforceable contract was formed, the customer's failure to timely pay constitutes a breach of contract
 - Offer
 - Acceptance
 - Consideration
 - Meeting of the minds

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JURISDICTION AND VENUE ISSUES

- Before filing suit against a customer, a threshold question must be answered: where do I file?
- Basic tenets:
 - File in the customer's home state OR
 - Where the customer has minimal contacts OR
 - The state in which the contract was negotiated/signed.
- Filing in U.S. District Court – depends on whether "diversity" jurisdiction exists:
 - Plaintiff and defendant in different states; and
 - LLC parties – complicates things!
 - At least \$75,000 at issue
- Forum selection clauses in contracts

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BREACH OF CONTRACT / UNJUST ENRICHMENT

- Potential damages for breach of contract include:
 - Compensatory damages, including expectation damages and consequential damages (i.e., loss of business profits)
 - Liquidated damages (if provided for in contract)
 - Punitive damages (rare in a breach of contract case)
- Equitable remedies are also available:
 - Specific performance
 - Contract rescission / reformation
 - Restitution (similar to unjust enrichment)

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BREACH OF CONTRACT / UNJUST ENRICHMENT

- Unjust enrichment: “where one person is unjustly or by chance enriched at the expense of another, and an obligation to make restitution arises, regardless of liability for wrongdoing.”
- Equitable remedy - generally assumes lack of a legal basis
 - If valid contract exists, breach of contract will usually be the appropriate remedy
 - Unjust enrichment generally used where there was no contract between the parties, or where the contract was found to be invalid

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BREACH OF DUTY OF GOOD FAITH AND FAIR DEALING

- All contracts have an implied covenant of good faith and fair dealing in the course of performance by the parties to the contract
- Can be asserted as a standalone, independent cause of action in a complaint, separate from, and in addition to, a breach of contract count
 - Typically asserted in addition to breach of contract claim
 - But can be asserted in lieu of breach of contract claim
 - For example, if there is on breach of contract, but a party took actions that defeat the essential purpose of the contract
- Embraces the concept that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract

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BREACH OF CONTRACT / UNJUST ENRICHMENT

- Timing
 - The statute of limitations for breach of contract varies from state to state, and are different for written and oral contracts
 - Written contract: ranges from 3 to 10 years
 - Note, however, that parties can agree – and may have agreed – to shorten the statute of limitations by contract
 - This is allowed
 - Oral contract: ranges from 2 to 10 years
 - Unjust enrichment claims have a similar statute of limitations

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BREACH OF DUTY OF GOOD FAITH AND FAIR DEALING

- Can arise when one party to a contract deceives the other party and delays or prevents the exercise of that party's contractual rights
- Breach of the implied covenant of good faith and fair dealing can stand as its own separate cause of action as long as it is distinct from any breach of contract claim
 - Courts often find that such a standalone claim exists where the party alleges some bad faith conduct that was not encompassed by the express obligations of the parties set forth in the contract
- However, if it is duplicative of a breach of contract count, the count based on a breach of the implied covenant of good faith and fair dealing might be dismissed
- Helpful to plead both, so long as there is a basis, so that if one is dismissed, perhaps the other count survives, leaving the lawsuit intact

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SELLER'S REMEDIES FOR BUYER'S BREACH

- Article 2 of the Uniform Commercial Code (UCC) affords a number of remedies to sellers of goods
 - Does not apply to those providing services
- If buyer wrongfully rejects or revokes acceptance of goods, or fails to make a payment due on or before delivery, or repudiates with respect to a part or the whole, the aggrieved seller may:
 - withhold delivery;
 - stop delivery by a bailee;
 - identify goods to the contract;
 - resell and recover damages;
 - recover damages for non-acceptance; or
 - cancel.
- Remedy applies to (a) any goods directly affected, and (b) if the breach is of the whole contract, then also to the whole undelivered balance.

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SELLER ELECTS TO RESELL GOODS

- Private sale
 - Seller must give buyer reasonable notification of intention to resell

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SELLER ELECTS TO RESELL GOODS

- As one option for buyer's breach, seller may resell goods or undelivered balance thereof (UCC § 2-703)
- Following a resale in good faith and in a commercially reasonable manner, seller may recover difference between resale price and contract price together with any incidental damages allowed under the provisions of Article 2 (UCC § 2-710), but less expenses saved as a consequence of buyer's breach (UCC § 2-708)
- Public vs. private sale
 - Must be commercially reasonable either way

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SELLER ELECTS TO RESELL GOODS

- Public sale
 - Generally, only identified goods can be sold
 - Must be at a usual place or market for public sale if one is reasonably available and, except in the case of goods which are perishable or threaten to decline in value speedily, seller must give buyer reasonable notice of time and place of resale
 - If goods are not to be within the view of those attending the sale the notification of sale, must state the place where the goods are located and provide for their reasonable inspection by prospective bidders
 - Seller may buy

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SELLER ELECTS TO SUE FOR WRONGFUL REJECTION OF GOODS

- Upon buyer's breach, seller can elect to sue for damages.
- Suit may seek:
 - Consequential damages – difference between (a) unpaid contract price and (b) market price at time and place for tender of delivery, (c) minus expenses saved as a consequence of buyer's breach (UCC § 2-708(1))
 - Incidental damages - any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation, care and custody of goods after buyer's breach, in connection with return or resale of the goods or otherwise resulting from the breach

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SELLER ELECTS TO SUE TO RECOVER PRICE OF GOODS

- Where buyer fails to pay price as it comes due, seller may recover the price:
 - of goods accepted or of conforming goods lost or damaged after risk of their loss has passed to buyer; and
 - of goods identified to the contract if seller is unable, after reasonable effort, to resell them at a reasonable price, or the circumstances reasonably indicate that such effort will be unavailing.

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SELLER ELECTS TO SUE FOR WRONGFUL REJECTION OF GOODS

- If consequential and incidental damages are inadequate to put seller in as good a position as it would have been in had buyer completed performance, seller can sue for:
 - Lost profits (UCC § 2-708(2))
 - Applies to unique goods, for example. Because unique good have no readily available market, calculation for consequential damages does not work.

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SELLER ELECTS TO SUE TO RECOVER PRICE OF GOODS

- Where seller sues for the price, seller must hold for buyer any goods that have been identified to the contract and are still in seller's control
 - If resale becomes possible, seller may resell goods at any time prior to collection of the judgment
 - Net proceeds of any such resale must be credited to buyer
 - Payment of the judgment entitles buyer to any goods not resold

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SELLER IDENTIFIES GOODS TO CONTRACT

- Means of expanding seller's damage claim
- Identify to the contract conforming goods not already identified if they are in seller's possession or control at the time of breach (UCC §2-703)
- Procedure expands seller's claim by including goods which have demonstrably been intended for the particular contract

LIQUIDATED DAMAGES

- Buyer and seller may include a liquidated damages clause in contracts for the sale of goods
 - The amount must be reasonable in light of anticipated or actual harm that could be caused by the breach
 - Unreasonably large liquidated damages are void as a penalty

SPECIFICS OF IDENTIFYING GOODS TO CONTRACT

- As to unfinished goods, seller may:
 - complete the manufacture and wholly identify the goods to the contract; or
 - cease the manufacture and resell for scrap or salvage value
- Seller's action must be based on commercially reasonable judgment

COMMON LAW FRAUD

- Frauds are actionable against the fraudster under the "common law" of all 50 states.
- In some cases, fraud claims can be pursued by statute (e.g., consumer protection laws)
- Elements of common-law fraud are generally:
 1. A false statement of material fact;
 2. The defendant's knowledge that the statement was false;
 3. The defendant's intent that the statement induce the plaintiff to act;
 4. The plaintiff's reliance on the statement; and
 5. The plaintiff's damages resulting from reliance on the statement.

COMMON LAW FRAUD

- Timing
 - Statute of limitations for common law fraud ranges from 2 to 10 years
 - Some states also incorporate the “discovery rule,” which provides that the statute of limitations clock does not start running until the fraud is discovered, or reasonably should have been discovered

ACTUAL FRAUDULENT TRANSFERS

- Under Section 5(a)(1) of the UFTA:

“A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation *with actual intent to hinder, delay or defraud any creditor of the debtor.*”

 - But how does one prove actual intent?
- Section 548(a)(1)(A) of the Bankruptcy Code corresponds to Section 5(a)(1) of the UFTA.

FRAUDULENT TRANSFERS

- In addition to common law fraud, actions may be brought to avoid and recover transfers that were fraudulent in nature.
- Can be brought under both state (Uniform Fraudulent Transfer Act) and federal (United States Bankruptcy Code) law.
- Two primary types of fraudulent transfers:
 - Actual fraudulent transfers (requiring proof of fraudulent intent by the transferor)
 - Constructive fraudulent transfers (which do not require proof of actual intent to defraud)

ACTUAL FRAUDULENT TRANSFERS

- Badges of Fraud: Section 5(b) of the UFTA provides that consideration may be given, among other factors, to whether:
 1. The transfer or obligation was to an insider;
 2. The debtor retained possession or control of the property transferred after the transfer;
 3. The transfer or obligation was disclosed or concealed;
 4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
 5. The transfer was of substantially all the debtor’s assets;
 6. The debtor absconded;
 7. The debtor removed or concealed assets;
 8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
 9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
 10. The transfer occurred shortly before or shortly after a substantial debt was incurred; and
 11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

CONSTRUCTIVE FRAUDULENT TRANSFERS

- Section 5(a)(2) of the UFTA also provides for avoidance of “constructive” fraudulent transfers when the debtor:
 - Did not receive “reasonably equivalent value” in exchange for the transfer or obligation, and
 - Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
 - Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they came due.
- Section 548(a)(1)(B) of the Bankruptcy Code corresponds to Section 5(a)(2) of the UFTA.

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GUARANTY ENFORCEMENT

- If a third-party has guarantied the obligations of the customer, the creditor also has the option of filing a lawsuit against the guarantor to enforce
- Does creditor have to exhaust remedies against customer first?
 - If guaranty is a guaranty of collection (aka “conditional guaranty”), all remedies against customer must first be exhausted
 - If guaranty is a guaranty of payment (aka “absolute guaranty”), creditor can pursue guarantor first, without having pursued remedies against customer

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WHEN MIGHT YOU BE A VICTIM OF A FRAUDULENT TRANSFER?

- Guarantor transfers all of its assets to prevent you from collecting on a judgment
- You receive payment from a corporate affiliate (rather than the direct obligor), despite that affiliate having no direct obligation to pay
- A substantial transfer of assets by a customer renders it insolvent (and unable to pay you)
 - To shareholders / owners
 - To an affiliate
 - To select preferred creditors
- A customer incurs a significant debt or secured obligation just prior to filing for bankruptcy
- A customer engages in inter-company transfers in order to duck its obligations, or shore up the liquidity of an affiliate or subsidiary

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GUARANTY ENFORCEMENT

- An action to enforce a guaranty will be brought in either state or federal court
 - Depending on jurisdictional concerns and choice of forum clause in guaranty
- Be aware of potential defenses of guarantor
 - Guarantor was not properly advised of pertinent facts
 - Creditor did not act in commercially reasonable manner
 - Lack of consideration
 - Unenforceable oral guaranty
 - Statute of limitations / doctrine of laches
 - Guaranty not signed by party to be charged or forged
 - Settlement with other guarantors limits liability of guarantor to be charged
 - Customer defenses (defective product, short deliveries, credits or allowance owed, or other offsets)

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GUARANTY ENFORCEMENT

- Timing
 - Statute of limitations for breach of guaranty actions will generally track the statute of limitations for breach of contract (since a guaranty is a contract)

TYPES OF PLEADING

- Complaint
- Answer
- Motion to Dismiss
- Motion for Judgment on the Pleadings
- Motion for Summary Judgment

DISCOVERY

- Various methods of discovering data and information
 - Requests to Admit
 - Interrogatories
 - Requests to Produce
 - Depositions
- Generally begins after an Answer is filed
- 30 days to respond to discovery requests, though usually more time is granted due to extent of requests

HELPFUL HINTS

- Document Management
 - Have a common filing nomenclature – makes access of documents easy;
 - The more organized, the less time your lawyers spend;
 - Be careful what you write
 - Notes on collections
 - Smart-aleck remarks
- Know your metrics
 - Don't sue when it will harm you in the long-run
 - Sometimes cheaper to write it off
 - Preserve relationships

UNDERSTANDING INVOLUNTARY BANKRUPTCY

- A bankruptcy case does not necessarily need to be initiated by debtor
- Creditors have right to file an involuntary bankruptcy petition against a debtor

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UNDERSTANDING INVOLUNTARY BANKRUPTCY REQUIREMENTS

- Claims held by petitioning creditors must be unsecured
- Query: Can a secured creditor that is undersecured join in an involuntary petition?
 - Yes
 - So long as the aggregate unsecured portion of the claims of petitioning creditors meets the statutory threshold

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UNDERSTANDING INVOLUNTARY BANKRUPTCY REQUIREMENTS

- Involuntary bankruptcy filing can be initiated by:
 - If there are 12 or more unsecured creditors:
 - Three or more such entities holding non-contingent, undisputed, unsecured claims totaling at least \$18,600 in the aggregate
 - If there are fewer than 12 unsecured creditors:
 - One such entity holding a non-contingent, undisputed, unsecured claim totaling at least \$18,600

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UNDERSTANDING INVOLUNTARY BANKRUPTCY REQUIREMENTS

- Requirement that claims held by petitioning creditors must be undisputed
 - Claims cannot be subject to a “bona fide dispute”
 - Most courts follow objective standard
 - Genuine issue of material fact bearing upon debtor’s liability on claim or meritorious contention as to application of law to undisputed facts
 - What is creditor’s claim is only partially subject to a bona fide dispute?
 - Courts have reached conflicting conclusions
 - Most recently, in the *TV Azteca* bankruptcy, the bankruptcy court in Manhattan dismissed an involuntary bankruptcy filed by three noteholders where the debtor disputed only a portion of the noteholders claims
 - » But did not dispute principal and interest that was owed, meaning that the bona fide dispute was only as to part of the claims of the petitioning creditors

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UNDERSTANDING INVOLUNTARY BANKRUPTCY

PROCEDURE

- Petitioning creditors file involuntary petition
 - Can be either chapter 7 or 11
- Debtor has 21 days to respond to involuntary petition if it so chooses
 - If debtor objects, court must determine issues raised by the contested petition as early as practicable
 - If debtor does not object, then order for relief is entered

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UNDERSTANDING INVOLUNTARY BANKRUPTCY

ELIGIBILITY OF DEBTOR

- If debtor objects to involuntary petition, court shall enter an order for relief only if:
 - Debtor is generally not paying debts as they come due unless such debts are subject to bona fide dispute as to liability or amount; or
 - A custodian was appointed to take possession of substantially all of debtor's assets within 120 days prior to filing of involuntary petition

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UNDERSTANDING INVOLUNTARY BANKRUPTCY

COMMON DEFENSES

- Common defenses that may be asserted by debtor include:
 - Lack of jurisdiction
 - Improper venue
 - Failure of petitioning creditors to meet dollar threshold
 - Too few petitioning creditors
 - Petitioning creditors claims are contingent and/or subject to bona fide dispute

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UNDERSTANDING INVOLUNTARY BANKRUPTCY

JOINER IN INVOLUNTARY PETITION

- Any other creditor may join an involuntary petition after it is filed but before the case is dismissed or an order for relief is entered
- A creditor who joins after the filing counts toward meeting the filing requirement
 - If a petitioning creditor is found to be ineligible, then a creditor who joined after the initial filing can count toward curing the defect

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UNDERSTANDING INVOLUNTARY BANKRUPTCY

EFFECT OF INVOLUNTARY FILING

- After an involuntary petition is filed but before case is dismissed or order for relief is entered:
 - Automatic stay takes effect immediately upon filing of involuntary petition
 - Debtor may continue to operate its business and continue to use, acquire or dispose of property as though the involuntary case had not been filed

UNDERSTANDING INVOLUNTARY BANKRUPTCY

RISKS

- There are certain risks attendant to an involuntary filing:
 - If petition is dismissed, court may award costs or reasonable attorneys' fees to debtor
 - If filing is found to be in bad faith, court may award:
 - Damages proximately caused by the filing; or
 - Punitive damages

UNDERSTANDING INVOLUNTARY BANKRUPTCY

WHY FILE AN INVOLUNTARY PETITION

- Reasons to file an involuntary bankruptcy include:
 - Prevent dissipation of assets
 - Prevent fraudulent transfers
 - In the event of corporate mismanagement, to trigger the automatic stay and to seek the appointment of a trustee
 - Trustee appointed automatically in a chapter 7
 - Prevent judgment creditor from collecting assets through judgment enforcement process
 - Preserve 503(b)(9) claims
 - Access to Rule 2004 discovery
 - Even without filing a lawsuit

UNDERSTANDING INVOLUNTARY BANKRUPTCY

RISKS

- After notice and a hearing, court may require petitioning creditors to post a bond to indemnify debtor for its costs or attorneys' fees in the event petition is dismissed
- Could file into preference liability
 - Review 90-day payment history
- **Proactive Pointer:** Be sure to evaluate risk factors before filing

QUESTIONS



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