

# Towards Bankruptcy-Proofing Client Service Agreements

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The never-ending quest for suppliers of credit is to create the contract that will insulate them from the consequences of bankruptcy filings by their account debtors. Personal guaranties and adequate collateral will insulate the blow, but it still leaves the PEO with an extant client service agreement (CSA) stuck in the middle of a Chapter 11 case with no guarantee of getting out. The reality is that there is nothing that you can do to insulate yourself completely through contractual provisions. However, carefully drafting the client service agreement can help alleviate some of the problems arising from the bankruptcy.

### Essential Bankruptcy Concepts

To understand what makes a contractual provision effective in bankruptcy and what does not, it is helpful to understand some basic facts about bankruptcy itself, specifically Chapter 11. First, upon filing a Chapter 11 petition, the debtor becomes a fiduciary to the creditor body as a whole. The failure of the debtor to conduct its affairs in this manner could result in a Chapter 11 trustee being appointed to run the business. That difference drives many of the things a court is or is not willing to do in the case.

Second, parties cannot agree in advance of a bankruptcy filing how the case will go. That function is left to the bankruptcy judge, usually after notice to creditors. Thus, an agreement to waive the automatic stay in advance of a bankruptcy filing is unenforceable in the bankruptcy. To be able to take action that would otherwise be prohibited by the stay—including the termination of the CSA—the creditor still needs to obtain an order from the court granting it relief from the stay.



### in a nutshell

- Upon filing a Chapter 11 petition, the debtor becomes a fiduciary to the creditor body as a whole. The failure of the debtor to conduct its affairs in this manner could result in a Chapter 11 trustee being appointed to run the business.
- If the PEO wants to terminate the contract, it would have to file with the court a motion for relief from the automatic stay. The court would determine at that hearing whether “cause” exists to allow the PEO to terminate the contract.
- The goal of the PEO would be to convince the court it would be harmed by the continued imposition of the stay, while the client would attempt to show otherwise. If the parties cannot agree on the facts, then the court would hold an evidentiary hearing. The PEO’s goal in drafting the CSA should be to try to get the client to agree to as many of these facts in advance of the bankruptcy to use at the hearing on the motion for relief from stay.

It would not be unusual, therefore, to hear a debtor state that while he understands that he made a certain agreement prior to a bankruptcy filing, he neither is bound by the agreement nor could he, consistent with his fiduciary duties, adhere to that deal. Indeed, the court will likely agree. In short, there is nothing one can put in the client service agreement that will guarantee to the PEO the ability to terminate it.

### Stipulations of Fact

Given that a pre-petition waiver of the automatic stay is ineffective post-bankruptcy, what, if any, provisions are effective? The short answer is that the closer the agreement can be construed as a stipulation of facts, the greater the chance it will have of being effective post bankruptcy.

To understand this concept, one only needs to look at how a PEO would go about protecting itself once a bankruptcy is filed. As discussed in February's feature ("Client Service Agreements as Executory Contracts: A Strategy for Getting Paid in Bankruptcy," available to NAPEO members at [www.napeo.org](http://www.napeo.org)), if the PEO wants to terminate the contract, it would have to file with the court a motion for relief from the automatic stay. The court would determine at that hearing whether "cause" exists to allow the PEO to terminate the contract. As a general concept, cause would exist if the PEO were to continue to be harmed by the imposition of the automatic stay. The goal of the PEO would, therefore, be to convince the court it would be harmed by the continued imposition of the stay, while the client would attempt to show otherwise. If the parties cannot agree on the facts, then the court would hold an evidentiary hearing at which witnesses would testify about the harm or lack of harm to the PEO.

The PEO's goal in drafting the CSA should be to try to get the client to agree to as many of these facts in advance of the bankruptcy to use at the hearing on the motion for relief from stay. Courts may give different weight to these agreed facts. Some may hold that they bind the client and its creditors. Others may find that

they do not bind the client, but that they can be used as evidence against the client. Others may hold that the client is bound by the pre-petition agreement as to facts, but that creditors may have the ability to contest them. Whatever the result, it is worthwhile putting provisions in the CSA that would tend to bind the client to facts helpful to the PEO should the client file a Chapter 11 petition, or at least an attitude about how the matter should be approached. These might include:

- A statement recognizing the importance of the client making its payments on time and the harm that would befall the PEO if the client fails to do so;
- A statement setting forth the risk undertaken by the PEO if the client does not pay;
- A statement that the client recognizes the importance of the ability of the PEO to terminate the client service agreement immediately upon default; and
- A statement recognizing the importance of a security deposit or advance payment.

The PEO may want to balance what it puts in the agreement against putting too much in writing about any vulnerability it may have in the event of default. Nor would it want to provide a roadmap to employees to assert claims against the PEO. Each PEO will have to make its own decision on this point.

### Agreements to Take Action

Another, although perhaps less effective, tactic would be for the client to agree in the CSA to take certain action in the event of a Chapter 11 case. While the PEO cannot bind the court to grant the PEO relief from the automatic stay to terminate the CSA or to set the standards for what constitutes "cause," inserting provisions in the agreement whereby the client promises to take certain actions in the event of a bankruptcy could serve two beneficial purposes. First, it gives the PEO the ability to argue that the position it is taking during the Chapter 11 case is something the client agreed to before the case and, as such, should be deemed reasonable. Second, it may have

the effect of asserting some moral pressure on the client to do during the Chapter 11 case what it had promised to do before the case was filed. Such provisions might include:

- An agreement for the client to file immediately a motion to pay pre-petition wages to the full extent allowed by law;
- An agreement that the client will file immediately a motion to assume the client service agreement;
- An agreement that the client will file immediately a motion with the court seeking to provide adequate assurance of performance in the form of a security deposit equal to either a set amount or formula (e.g., the highest payroll during the previous three months); and
- An agreement that the client will, as part of the PEO's adequate assurance of performance, seek to have the court approve an agreement that the PEO may terminate the client service agreement without further court order if the client fails to make payments timely during the Chapter 11 case.

### Conclusion

The foregoing items are but some of the examples of the types of provisions the PEO may want to include in the CSA. Including them will not guarantee a better result in the Chapter 11 case. That will depend largely on the positions taken by the client and its creditors in the Chapter 11 case and the attitude of the bankruptcy judge towards provisions of this type. Whatever the result, their inclusion in the contract will give the PEO a weapon it did not otherwise have in its fight to prevent against continuing risk of loss when the client becomes a Chapter 11 debtor.●

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