

Counterclaims

Prevention & Risk Management Strategies for Creditors

PREPARED FOR



PRESENTED BY



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Introduction

CREDITORS' GOALS

Creditors' goals are straightforward: collect the highest possible percentage the amount due and owing, as cheaply and quickly as possible.



DEBTORS' INCENTIVES

Debtors' incentives are the opposite:

- Drive up collection costs (in order to dissuade creditors from pursuing collection); or,
- At a minimum, convince creditors to accept a reduced sum (i.e., below what would be achieved absent collection costs).

Introduction

- To accomplish their goals, debtors employ a variety of familiar tactics.
- Today I will focus on an increasingly common tactic: filing counterclaims against creditors.
- Although the U.S. litigation system makes it impossible to eliminate counterclaims, careful planning can reduce their likelihood and limit the risks associated with them.

Overview

- Background
- Why do debtors file counterclaims?
- Counterclaims in creditor-debtor litigation
- Prevention and risk-management strategies
 - Contractual tools
 - Noncontractual tools
- Litigation strategy on counterclaims
 - Motions to dismiss
 - Other early pressure
- Settlement strategies on counterclaims

Background

15 YEARS

— OF —

**Experience
in Creditors'
Rights**

AREAS OF FOCUS

Banking



Insurance

Service
Contracts



30

— TO —

40%

**of cases involve
counterclaims**

Litigation is
backward-looking



Goal of this
presentation is to
use lessons learned
in litigation to inform
practices and
procedures to better
prevent and manage
counterclaims

Why Do Debtors File Counterclaims?



Why Do Debtors File Counterclaims?



Nothing to Lose

- The debtor is already involved in the suit
- Very small cost
- Perception that liberal pleading requirements make dismissal of claims difficult
- Relationship with creditor is already broken

Why Do Debtors File Counterclaims?



Compulsory

- Any claim that arises out of the subject matter of the collection action must be asserted as a counterclaim, not as a separate suit;
- Failure to assert the counterclaim results in waiver.

Why Do Debtors File Counterclaims?



Economic Leverage

- Collection suits are generally handled on a contingency fee, with fixed creditor risk equal to the dollar value of percentage paid.
- Counterclaims are generally defended hourly, with varied risk depending on how the matter is litigated.
- A counterclaim, unlike ordinary defenses, creates a risk of affirmative payout by the creditor.
- Modern legal practice's emphasis on discovery increases the strategic value of inflicting early financial pain.

Why Do Debtors File Counterclaims?



Narrative Shifting

- The debtor can shift the focus toward the creditor's conduct—and away from its own nonpayment.
- Recent high-profile financial services cases have given rise to anticorporate animus, to which this narrative plays:
 - Robosigning mortgage cases in Florida
 - Fraudulent account opening by large bank
 - Privacy breaches

Counterclaims in Creditors' Rights Litigation

- Breach of Contract
 - The creditor's failure to honor its own contractual obligations negates the need for the debtor to pay the amounts otherwise owed under the contract.
- Fraudulent Misrepresentation
 - The creditor's formula for calculating the debtor's damages is not just incorrect, but it gives rise to a legal claim for fraud.
- Negligent Misrepresentation
 - The creditor misrepresented information in order to induce the debtor into contracting with the creditor, such that the debtor is not obligated to pay.

Counterclaims in Creditors' Rights Litigation

- State Consumer Fraud Statutes
 - Similar to fraudulent/negligent misrepresentation, but with reduced standards of proof
- Breach of Fiduciary Duty
 - Creditor owed an extraordinary duty to the debtor, and breached that duty
- Negligence
 - Creditor breached duty in its actions related to the debtor, causing damages to the debtor

Counterclaims in Creditors' Rights Litigation

- **FDCPA**
 - Debtors will sometimes assert that attempts to collect against them violate the Fair Debt Collection Practices Act, which only applies to consumers and against third-party debt collectors.



Risk Management on Counterclaims: Contractual Tools

- All creditors' rights litigation originates with contracts.
- Careful drafting of debtor contracts can not only aid in offensive litigation, but also in minimizing counterclaim risk.

Risk Management on Counterclaims: Contractual Tools

- Integration Clause
 - Bars the use of precontractual communication to support counterclaims
 - Assists in dismissal of any noncontractual claims
- Damage Limitation Clauses
 - Limiting type of damages (e.g., lost profits)
 - Limiting damages to amount of loan
- Claim Limitation Clauses
 - Precluding certain noncontractual claims (e.g., tort/statutory claims)

Risk management on counterclaims: contractual tools

- Clear Language on Invoice Process and Timing of Disputes
 - Contracts should outline the invoicing and dispute process, including escalation and appeal of billing disputes.
 - Contract should clarify that bills not challenged within ___ days are presumed valid, and failure to satisfy this condition bars any claims related to the invoices at issue.
- Clear Language on Duty
 - Language should clearly outline the scope of the creditor's duty in relation to the debtor.
 - Language should disclaim any duties over areas that could give rise to counterclaims.

Risk management on counterclaims: contractual tools

- Contractual Harmonization
 - If different contracts are employed, make sure that they harmonize with one another.
- Dispute Resolution Clause
 - Lay out a clear set of steps that must be undertaken prior to filing suit, including a discussion between the parties and mediation.
- Arbitration Clause—Utility depends on context
- Attorney's Fees to the Prevailing Party
- Choice of Law Clause—Avoid states with weak enforcement of contractual language.

Risk management on counterclaims: other tools

- Engage in regular feedback and discussions with problem debtors; document interactions with debtors
- Identify Risky Debtors Prior to Filing Suit
- Carefully analyze file correspondence to determine the likelihood of drawing a counterclaim; consider accepting a reduced sum and avoiding litigation.
 - Threats to involve an attorney?
 - Specific allegations?
 - History of litigious conduct?

Litigation strategy on counterclaims



The first response to a counterclaim is key

Rule

1

Never reduce a settlement demand immediately in response to a counterclaim.

- A weak response emboldens the debtor.
- A strong response shapes future negotiations.

Rule

2

Do not reflexively file an answer that simply denies the allegations; instead, carefully analyze the counterclaims.

- Most debtor counterclaims are weak and designed solely to create leverage.
- While a simple answer is cheaper in the short term, it could be more costly overall (expands the scope of discovery; may decrease the net case value).

Litigation strategy on counterclaims

- Guiding Principles on Litigation Strategy
 - Most counterclaims are defense strategies disguised as an offensive claim.
 - The default position should be to treat such “claims” with skepticism.
 - If the debtor’s goal in pursuing a counterclaim is to force the creditor to confront the time/expense associated with a response, then the corollary is also true: debtors must be held accountable for filing a counterclaim—in the form of a time/monetary investment.
 - Debtors’ counsel rarely spend time drafting counterclaims, so even meritorious claims can be dismissed.
 - Motions to dismiss counterclaims related to collection-type suits are generally narrow in scope, which reduces the cost.

Litigation Strategy on Counterclaims

Recommended Two-Step Process on Counterclaims

STEP 1

If matter is amenable to settlement, identify counterclaim weaknesses in settlement negotiations while threatening to file a motion to dismiss.

STEP 2

If matter is either (a) not resolved; or (b) not amenable to settlement in the short term, move to dismiss the counterclaim.

Litigation strategy on counterclaims

- Advantages to Moving to Dismiss
 - A lot of debtors' attorneys promise their clients that the mere filing of a counterclaim will force a walkaway by the creditor.
 - A motion to dismiss forces the debtor to immediately incur fees responding to the motion to dismiss, which may surprise the debtor client.
 - The odds of success are higher than in a motion to dismiss original claims:
 - Debtor must defend claims that are really disguised defenses;
 - Claims are generally weakly pleaded; and
 - The presence of a contract—and carefully crafted provisions—provide unusually good arguments for dismissal.

Litigation strategy on counterclaims

- Advantages to Moving to Dismiss
 - Anecdotally, a lot of cases are resolved shortly after filing a motion to dismiss.
 - Even a partial dismissal (a) limits the scope of discovery; and (b) may require the debtor to replead its claims.
 - If a counterclaim is not dismissed—and ends up in trial—the presence of a counterclaim could facilitate the “split the baby” result that the debtor desires.

Litigation strategy on counterclaims

- Motion to Dismiss Arguments
 - Economic Loss Doctrine—Where plaintiff's damages are only economic in nature, a party cannot seek relief in tort, and is instead limited to contractual relief.
 - Damage/Claim Waiver—Dismissal of claims based on damage/claim waiver language in the contract
 - Integration Clause—Claims relying on extracontractual representations—e.g., negligent misrepresentation—should be dismissed. (Fraudulent inducement claims generally survive despite an integration clause.)

Litigation strategy on counterclaims

- Motion to Dismiss Arguments
 - Failure to Satisfy Conditions Precedent—If there is strong language requiring that bills be disputed within a particular time period, this argument can warrant dismissal of claims.
 - First Party Creditor—The FDCPA does not apply to first-party creditors, which is a basis for a motion to dismiss.
 - Lack of Duty (Generally)—Many claims will seek relief based upon fictional duties extraneous to the contract; so good contractual language based on scope of duty can aid in dismissal of particular claims.
 - Lack of Fiduciary Duty—Generally, a creditor is not a fiduciary of a debtor, warranting dismissal of a breach of fiduciary duty claim.

Litigation strategy on counterclaims

- Other Litigation Strategies
 - If the odds of dismissal are low, other strategies can still impose early pressure on the debtor
 - Immediately serve discovery related to the counterclaims:
 - Force the debtor to articulate the factual and documentary basis for its claims; and
 - Force the debtor to expend time and resources responding to the discovery.
 - Any strategy that makes clear—to the debtor—that the counterclaim tactic did not yield results is good for positioning a case.

Settlement strategy on counterclaims

- In addition to ordinary considerations on settlement, creditors should also account for:
 - Likelihood that settlement will incentivize copycat counterclaims;
 - Effect of settlement on related litigation;
 - Probability that similar allegations will repeat themselves in other litigation;
 - Ability to maintain confidentiality;
 - Whether the company wishes to do business with this debtor in the future.
- Creditors should always insist on a confidentiality/non-disparagement clause in any settlement.

Thanks so much for your kind attention.

Questions?

Please feel free to contact me at:



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