War Story

Nonpayment of Fees

By: Randy Werner, J.D., LL.M./Tax, CPA

Hope Accounting & Auditing (HAA) had performed financial statement audits for Pulp Fabrication (PF), a large paper products manufacturing company, for several years. PF had been a good payer of fees, though the recession had caused some cash-flow problems and caused PF to make partial payments to HAA until it was able to make payments in full. This required extra patience on the part of HAA collections, which waited until the end of the month to bill, but that patience was usually rewarded with tardy payments in full.

During the last audit, PF made a partial payment on the audit fees after the first month's billing, and another partial payment after the second month's billing. The engagement appeared to be going well, but right after the second partial payment, PF's largest customer, which accounted for almost half of its revenues, became bankrupt. At this point PF was no longer able to pay the audit fees.

PF management did not want the auditors to know what had happened with its major client, because it needed a clean financial statement audit in order to qualify for more credit, which it needed in order to pay the HAA invoices. When its payments to HAA got behind schedule, the HAA collection callers were told that the payments were scheduled for the next payment cycle.

HAA continued to perform work for PF in spite of no more payments being received. HAA auditors finally learned about the bankruptcy of PF's largest client and about PF's inability to pay the outstanding fees unless it could qualify for a higher credit limit, but by then HAA's fees had accumulated to over $100,000.

The fees owed by PF had become so large that HAA wanted to sue for them, but PF was unable to pay the fees and had nothing to lose by countersuing HAA for malpractice. HAA consulted with its legal counsel and found that the legal fees that would be incurred as a result of two lawsuits, and the billable time lost by the firm due to litigation, would certainly exceed the amount of fees owed to the firm.

LOSS PREVENTION TIPS

Do not allow fees to build up to the point where you can no longer walk away from them. Always include a stop-work clause in the engagement letter, and enforce the clause according to the terms in the engagement letter.

Consider billing more frequently than monthly, as smaller invoices are paid sooner than larger ones. Billing weekly may be a better option.

Before reaching the point of no return, make a business decision about how much the firm is willing to lose in the form of accounts receivable for each client. At what point will the firm stop work for a client—at what amounts owed, at what dollar limit—until the client brings the payments up to date? Where is the point of no return?

Claims experience shows that simple fee disputes are better resolved through mediation and arbitration than through litigation. Mediation for all disputes is recommended as a first step, and binding arbitration—for fee disputes only—as a second step. Include a mediation clause in your engagement letter for all disputes, and a binding arbitration clause for fee disputes only. Have the letter signed by the client.

While arbitration is recommended for fee disputes, it is not recommended for all disputes, as the limitations of the arbitration process may constrict and impair a legal defense when compared to litigation. Most engagements, when in dispute, tend to produce complex, high-risk, high-dollar disputes that are better managed through litigation than arbitration.

WHAT ARE THE FIRST STEPS TO TAKE WHEN A CLIENT IS NOT PAYING?

Good communication with a non-paying client will either spur payment or set up circumstances that will make a potential demand for arbitration more effective. This involves sending a series of three letters requesting payment and communication from the client:

1. The first letter politely notes the nonpayment of fees owed, requests payment, and asks if there is any reason for the delay in payment.
2. The second letter is a reiteration of the first letter.
3. The final letter notes the continued nonpayment, and it requests a call to discuss payment arrangements by a specified deadline date, stipulating that if no call is received by the date, the result will be a demand for arbitration concerning the fee dispute, effective as of that date.

The purpose of the letters is to show that the client, by not responding to them, did not have any valid basis to claim that the fees were not owed. Had there been any dissatisfaction with the work, the client would have communicated it when given the opportunity.

Always consult with your legal counsel and liability insurer when considering the options, risks and consequences of efforts to collect fees. Lawsuits and counter-suits almost always result in the firm spending far more in attorney fees and in lost billable time than is warranted for the fees owed to the firm.

Randy Werner is a loss prevention executive with CAMICO (www.camico.com). She responds to CAMICO loss prevention hotline inquiries and speaks to CPA groups on various topics.

CONTACT US

CAMICO Mutual Insurance Company
1800 Gateway Drive, Suite 300
San Mateo, CA 94404
T 800 652 1772 or F 800 227 2090

Editor's Notes: "War Stories," drawn from CAMICO claims files, illustrate some of the dangers and pitfalls in the accounting profession. All names have been changed. CMIWSLAMLVCE120314.