Talk Softly and Carry a Big Stick: Dealing with Businesses in Financial Distress

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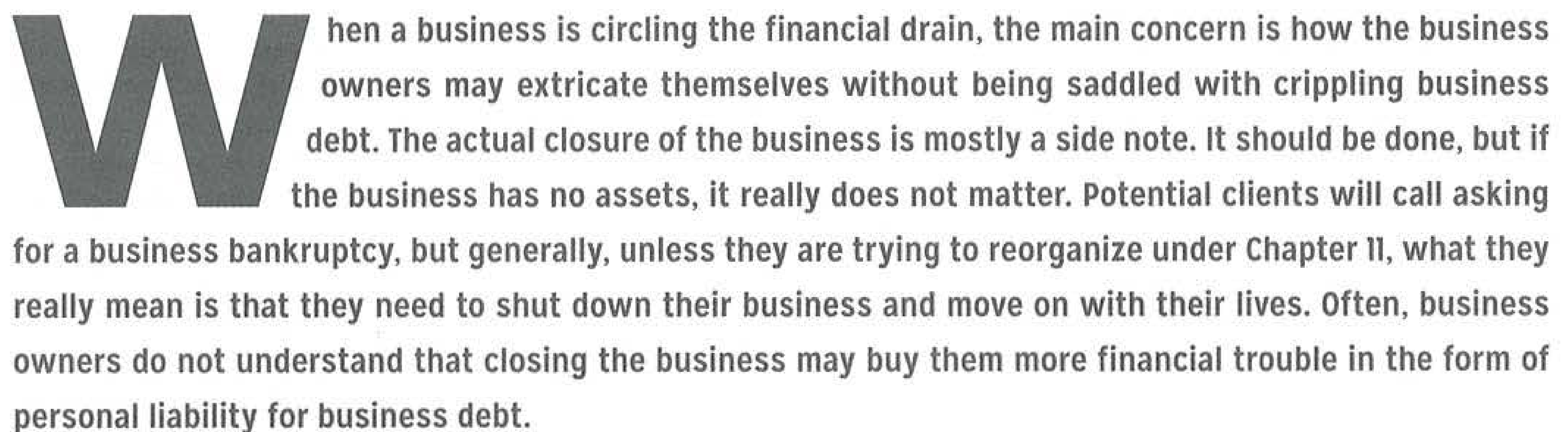
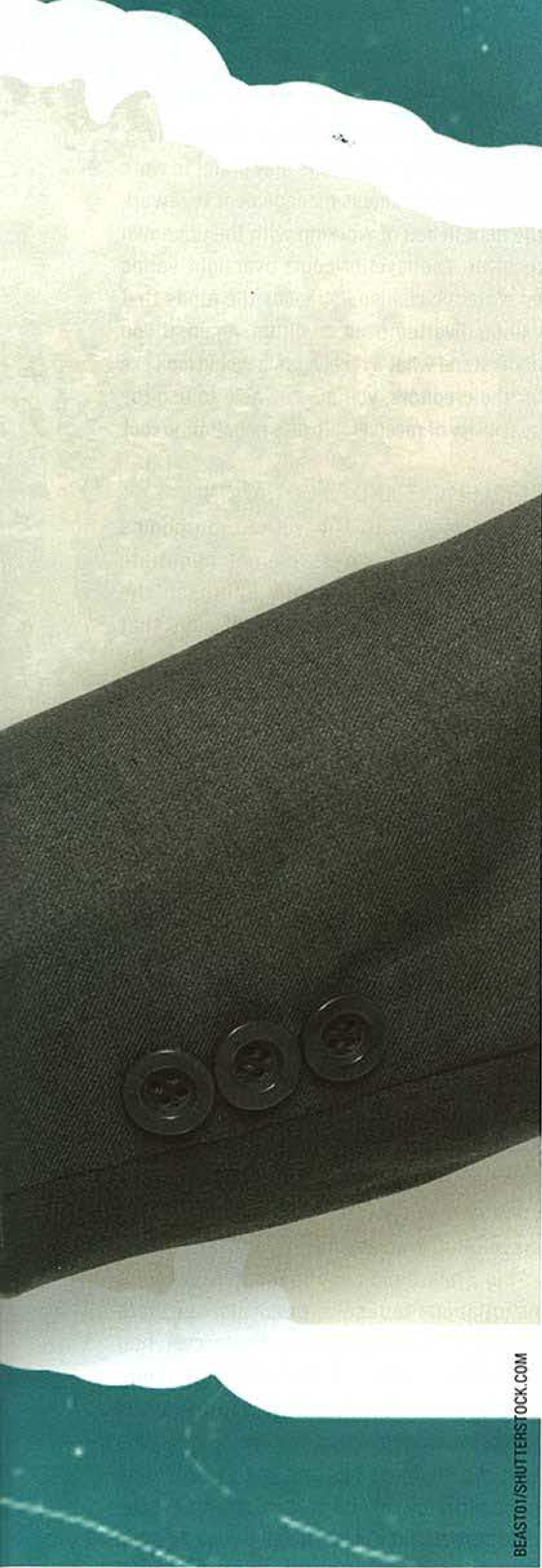


When a business is circling the financial drain, the main concern is how the business owners may extricate themselves without being saddled with crippling business debt. The actual closure of the business is mostly a side note. It should be done, but if the business has no assets, it really does not matter. Potential clients will call asking for a business bankruptcy, but generally, unless they are trying to reorganize under Chapter 11, what they really mean is that they need to shut down their business and move on with their lives. Often, business owners do not understand that closing the business may buy them more financial trouble in the form of personal liability for business debt.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It is these folks that require a more strategic approach to business closure. If business owners have no other significant debt, they cannot conceive of filing a personal bankruptcy. They also generally have no memory or records of signing personal guarantees. Sometimes there is a personal guarantee, but with the right planning that does not mean a creditor will pursue litigation for its enforcement and a personal bankruptcy may still be avoided.

In these situations, to paraphrase President Theodore "Teddy" Roosevelt, it is ideal to talk softly and carry a big stick. Such is the doctrine of Big Stick Diplomacy, peaceful negotiations with the unspoken threat of military force if they fail. Such is also the case when dealing with the creditors of a failing business, but instead of military force as the big stick, you have state law and the bankruptcy code. If you do not have a big stick to wield over the creditors of the defunct business, you might as well skip negotiations and go bang your head against the wall. This article will focus on what you can use as your big stick to reach a non-bankruptcy resolution of business debt and by extension business owner debt. Dealing with the IRS is a completely different animal, but generally a business owner will be given a workable repayment plan to deal with trust fund tax liability without the need for a plan of reorganization.

BANKRUPTCY AS THE ALPHA AND OMEGA

The analysis should begin and end with bankruptcy. If you know your end game, you can talk softly and carry a big stick. Creditors may rant and rave or threaten to play hard ball, but if you are armed with the facts of what will happen without a concession by creditors, the creditors' words are just sticks and stones.

Essentially, work backwards. Determine what will happen if the business owner is unable to negotiate with creditors or they are so aggressive that court intervention is required. Plan a personal bankruptcy for the business owner, plan a bankruptcy for the business, evaluate an Assignment for the Benefit of the Creditors (ABC) and a receivership. Know what will happen to the creditor in each scenario. Any settlement offer should purport to give the creditor a better deal than the creditor would get outside of settlement. Included in the analysis should be a reminder that if all goes badly, the creditor could have a Chapter 7 Trustee knocking at the door to claw back funds or argue preference. In addition, if the creditor cannot produce a written personal guarantee there may be enforcement problems or the inability to file a valid proof of claim. In addition, there is always the issue of attorney fees. If a creditor brings an action to enforce a debt, the creditor will incur attorney fees that may or may not be awarded in a judgment. Regardless, they may never be reimbursed because the business simply has no money to do so.

If you can get your client comfortable with what the client will see as the worst-case scenario (filing bankruptcy), it will also make your job easier. Any outcome that avoids filing a personal bankruptcy, appointing a receiver or instigating an Assignment for the Benefit of the creditors, makes you a rock star in your client's eyes. It is liberating to be able to state the facts to a creditor of what will happen (much like a decision tree—if X, then Y, and if Y then Z) without a negotiated resolution, knowing that your client is agreeable to whatever outcome occurs. It also helps your client to know there is a light at the end of the tunnel even if that entails filing a personal bankruptcy. Your time is well spent, preparing your client for the personal bankruptcy option. Additionally, prepping a business owner's personal bankruptcy at the onset of dealing with the failing business will allow you to see the potential landmines and have time to alleviate them. In short, you will be ready no matter what happens.

If a business owner has other nonbusiness-related reasons to file bankruptcy, there is no reason to go through the gymnastics of a formal dissolution process. Have the business owner purchase the business assets in exchange for assuming the business liabilities and file a personal bankruptcy for the business owner. This will resolve all personal guarantees as well as, potentially, handling any trust fund tax debt. The business owner may (read: will) receive dunning notices for the closed business in perpetuity, but upon discharge, the business owner will no longer have any personal liability for that debt.

Filing a Chapter 7 bankruptcy for a failing business itself is, at times, akin to a financial colonoscopy for the business owners. Given businesses do not receive a discharge and there are no exemptions for a business in a Chapter 7 bankruptcy, there is little upside. However, as a negotiation tool it may be helpful to use as a worst-case scenario for creditors. Any funds the Chapter 7 Trustee collects will go to pay Trustee's fees (thus, less for creditors) and it could be a long time before creditors receive any payment at all. If the Chapter 7 Trustee digs in for a lengthy forensic financial analysis, any funds collected could go to pay the Trustee's attorney fees. As a practical matter, a statutory dissolution generally obtains the same results with less scrutiny.

THE BUSINESS OWNER'S STORY MAY BE A TOOL

Business owners with a failing business always have a story, learn it. Sometimes your client's story holds some useful nuggets to use in negotiations with a creditor. For example, if the business is failing because the owner died with no life insurance, thus, leaving a spouse with seven kids to raise alone while contending with a business that was driven by the deceased spouse's services, stick that arrow in your quiver. The client's situation is terrible, but if using it helps make it part of the narrative (read: shaming creditors for demanding money from the mouths of babes).

While it is true that creditors cannot get paid when there is no money, they will rarely just stop trying to collect and go home. Having a solid and consistent narrative goes a long way toward making the pursuit of personal guarantees or an investigation into fraudulent transfers/preferences unattractive.

STATUTORY BUSINESS DISSOLUTIONS

Every state has laws on the dissolution of businesses and the procedures for winding up its financial affairs. If you do not know your state's law on business dissolutions and winding up, learn them. They may be invaluable in dealing with creditors. For example, in Arizona, there are statutory provisions for notifying creditors of a business' dissolution. Creditors are given 120 days to file a claim for payment by the business or forever hold their peace. During the 120-day time frame, businesses liquidate their assets and the money collected goes to pay claims received on a pro rata basis. This is a powerful tool when negotiations have failed or when attempting a negotiated settlement. Shockingly, many creditors fail to file claims or if they do, they largely go silent afterwards.

The bad news is that in many states there is no oversight to a statutory dissolution which is bad because there are no bright line rules. Using the bankruptcy code as a guide for distributions to creditors is a reasonable alternative when state law is silent. Also, use a good dose of common sense and remember the old adage that "pigs get fat, and hogs get slaughtered." If the business owner is merely a piglet and so are you with the administrative expenses you incur, likely a creditor is not going to get into the litigation weeds with you.

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Even if you do not have robust state business dissolution laws like Arizona, every state has statutes detailing the dissolution and winding up of businesses. Study these statutes and discover the treasures they hold.

OTHER STATE LAW TOOLS—ABCS AND RECEIVERSHIPS

An Assignment for the Benefit of Creditors (ABC) is a mechanism for a failing business (or individual) to assign all of its assets to an assignee so they may be sold to pay its creditors. The difference between an ABC and a state law dissolution is that a third-party assignee liquidates the assets and distributes the funds. ABCs vary by state and are governed by state law. In some states, there is very little court oversight and in others, the entire ABC is under court scrutiny. Again, just like with bankruptcy, look at this as a viable option for your client's business. If it is a viable alternative, it may be the quickest way to extricate your client from the business and the rigors of winding up the business. If an ABC is a viable option, but your client does not want to take it, you may be able to use it as a negotiating tool. If you can offer something that is better than what a creditor would get in an ABC, the creditor may accept a settlement offer.

Receiverships are another state court remedy for failing businesses. Typically, receiverships are used to help a failing business get back on its feet by appointing a third-party to step in and run the business. The goal is to make the business profitable again, but many times that it is not possible and the receiver will liquidate the business. Receiverships tend to be expensive, and creditors may not want business funds used to pay the receiver instead of the business' debts. In addition, creditors may prefer to work with current business management to rework the debt in lieu of working with the unknown receiver. The level of court oversight varies by state which also increases the funds that will be diverted from creditors. Again, if you understand what a receivership would look like for the creditors, you may be able to use the possibility of receivership as a negotiating tool.

SETTLEMENT AND NEGOTIATION

Once armed with the various outcomes if the failing business cannot negotiate its liabilities, strategically approach the creditors. There is nothing that says that a business cannot liquidate some or all its assets prior to starting a formal winding down process using state law. Many times, while keeping an eagle eye out for preferences and fraudulent transfers, the business may choose to retire some smaller debt or attempt a settlement of some debts while there are still assets to use towards that end. Once a formal dissolution starts, in most states as well as in bankruptcy, the business owner loses control of how to distribute assets and cannot direct them in a way that may benefit the business owner in the long run. If there is one aggressive creditor with a personal guarantee, the business owner may want to attempt a resolution with that creditor. The acceptance or rejection of any offer by that creditor may drive the rest of the business dissolution and closure.

Big Stick Diplomacy mandates peaceful negotiations to resolve problems, but there are consequences backed by force when negotiations fail. In the case of failing businesses and their creditors, you may speak softly when explaining the various options that the business has and use the outcome of bankruptcy, an ABC or receivership for the creditors as your force. Ideally, you can keep the business owners out of bankruptcy, but if not, proceed with your carefully, pre-planned end game. ■

ABOUT THE AUTHOR

Lisa C. Thompson *is licensed in Arizona, California and Nevada. She focuses her practice on consumer bankruptcy, general business law, CTA compliance, and business reorganizations If the economy is good, she is setting businesses up, maintaining them and if they are in financial distress, she talks softly and carries a big stick.*