

Navigating Financial Distress in Small Businesses

When a small business runs into serious financial trouble, the stakes are high for owners, creditors, and advisors alike. This course examines the legal and financial landscape facing distressed businesses, including options short of bankruptcy and the real-world consequences of insolvency. Drawing on practical examples, it helps CPAs and tax professionals recognize warning signs early, understand available remedies, and provide clients with informed, timely advice when they need it most.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 6

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 6 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the characteristics of the various chapters of bankruptcy.

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Chapter 1: THE FINANCIALLY TROUBLED BUSINESS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the characteristics of the various chapters of bankruptcy.

A new business doesn't come with a guarantee. Even with the best planning, it's possible that your business will go through hard times and maybe even fail. Many an entrepreneur has weathered a number of shaky ventures before landing in a business that proved solidly successful. So if your business becomes troubled or even if it needs to be put out of its misery, it shouldn't be viewed as the end of the world.

And, although it's always unpleasant—and can be heartbreaking—to have your business go bad, it's important to understand that there are many steps you can take to limit your losses so that you can get back on your feet and move on to other, more productive ventures. Especially if faced promptly, business troubles don't have to be long-term financial disasters.

A key economic preservation strategy is to protect your personal assets from business debts to the greatest extent possible. How you organize and run your business can make a decisive difference in whether you're able to do this.

In addition, if your enterprise should find itself in financial trouble, your day-to-day management decisions should be guided at least in part by your knowledge of what legal and business actions can help or hurt your personal situation.

Finally, if your financial troubles become so severe that you consider ending your business and maybe even declaring bankruptcy, you'll need to know exactly what legal options and protections are available.

THINKING AHEAD TO PROTECT YOUR PERSONAL ASSETS

Perhaps you personally own a home, a valuable car, stocks and bonds, or a savings account. Or maybe you own a second business or other valuable assets. Whatever you own, one thing is sure: You don't want to see everything you've acquired gobbled up by debts resulting from a failed business. Fortunately, with some advance planning, you can often protect many of your personal assets from your business creditors.

Caution!

Early planning is essential. It's crucial that you develop your asset protection plan as early as possible—preferably before rather than after you begin doing business. Once your business is in operation—and especially after it runs into financial trouble—you'll be greatly restricted in the steps you can take to protect your personal assets.

Choice of Business Entity

When you start your business, insulating yourself from personal liability for business debts and liabilities is one important consideration. This is especially true if there's a strong possibility that the business's failure would leave you with a huge stack of bills or lawsuits for uninsured liabilities. If you organize your business as a sole proprietorship or partnership, you'll be personally liable for all obligations of the business. If, however, you organize your business as a corporation or a limited liability company (LLC), your personal liability will be substantially limited. Or, to put this more bluntly, corporations and LLCs offer the greatest opportunity for protecting your personal assets from business obligations.

Beware of Penniless Partners

Another good reason to start your business as a corporation or an LLC rather than a general partnership— or to switch your existing partnership to a corporation or an LLC—is to protect yourself from the possible insolvency of any co-owners that could leave you stuck with all the business liabilities. The potential problem of working with co-owners in the context of a partnership is that if your business goes bad, you and your partners will be liable “jointly and severally” for business debts. This legal jargon means if any partners can't pay their shares of business debts, the others will have to make up the difference. So if you operate as a partnership, at least make sure your partners have enough assets to pay their shares of any partnership debts.

Example

Gianna has two partners when her partnership business fails, leaving \$30,000 in unpaid bills. Creditors get a judgment for \$30,000 against all three partners. Unfortunately, Gianna's partners don't have any assets. Under the doctrine of “joint and several liability,” Gianna is legally on the hook to pay the entire judgment.

Assuming that Gianna pays the entire \$30,000 judgment and the partnership agreement makes all the partners equally liable for business debts, she'll be able to collect \$10,000 from each of the other partners if they come into some money in the future.

Personal Loan Guarantees

Even if you form a corporation or an LLC to insulate your personal assets from business debts, you might be asked to put your personal assets on the line if your business applies for a bank loan or line of credit. Commercial lenders particularly won't make a loan or extend a line of credit to new corporations or LLCs unless the business owners personally guarantee to repay it. Unfortunately, if you agree to do this and your business later is unable to make payments as they come due, the lender has a right to get a judgment and collect it from your personal assets exactly as if you hadn't formed a corporation or an LLC in the first place.

In some cases, the requirement that you personally guarantee a potential loan might be enough to dissuade you from borrowing the money in the first place. In unusual circumstances, a lender might agree to put a cap on the amount of your guarantee so your personal assets aren't fully at risk. Or, if you can't sell that idea, try for a written commitment that your personal guarantee will expire after a preestablished period of time—perhaps two years—if the corporation or LLC has made all payments on time and is profitable.

Having Your Spouse Sign Too

If a lender asks you to personally guarantee a line of credit or a loan for your corporation or LLC, the lender might also ask for your spouse to be a coguarantor. A lender might make a similar request whether you open a line of credit or take out a loan as a sole proprietor or partner. Be aware of the additional risk this entails.

In most states—except for the nine that follow the community property system—if you alone sign for a line of credit or a loan and don't pay on time, the creditor can get a judgment against you but not against your spouse. So, ordinarily, a creditor will be able to reach the property that you own in your own name, but not the property that you and your spouse own in both your names.

However, if you and your spouse both sign on the dotted line, the creditor's rights will be much greater. Now if you and your spouse own property in your joint names—a home or bank account, for example—the creditor will be able to sue and get a judgment against both of you if the debt isn't paid. Then the creditor can enforce the judgment by seizing your joint bank account or jointly owned securities or home in addition to property you own in your name alone. The creditor will also be able to go after property that's in your spouse's name alone—and even to garnish your spouse's paycheck.

Caution!

Both spouses are liable for most debts in community property states. Nine states follow the community property system: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In those states, a married couple's property accumulated after marriage is primarily community or jointly owed property regardless of the names in which it's held. Each spouse can also own separate property but, especially in longer marriages, this tends to be less important. In most instances, the rights of creditors vary, depending on the type of property involved, as discussed below:

- **Community property.** Usually, property earned or acquired by either spouse after marriage—except by gift or inheritance—is at risk for a debt incurred by either spouse. This means a creditor can go after the community property of you and your spouse to pay off a debt, even if only you signed for the loan. In other words, you can't shield the community property from a creditor by not having your spouse sign for the loan.
- **Separate property.** This usually is property a spouse owned before getting married, acquired later by gift or inheritance, or agreed in writing would be kept separate. It's also property—such as a business—acquired from separate assets. If, for example, someone gets married owning a piece of real estate, sells it, and uses the proceeds to open a business, the business is separate property. If your spouse has separate property and signs for a loan, that spouse's separate property will be at risk if you default—but if your spouse declines to sign, that separate property will normally be beyond the creditor's reach. Your own separate property, of course, will be at risk whether or not your spouse signs.

Pledging Collateral for Loans

In addition to asking you to personally guarantee a loan by signing a promissory note, a lender might ask you to pledge a personal asset—typically, your home—as collateral for a business loan. In the case of your home, this would be done through a second mortgage or deed of trust. Think long and hard before you agree to do this, because it means you'll lose your home if you can't repay the money and the lender exercises its right to foreclose.

It's important to understand that there can be a big difference between simply putting your personal signature on a promissory note (see “Personal Loan Guarantees,” above) and giving the lender a security interest in property such as your home. The reason is that states have debtor protection laws (called “homestead laws”) that protect your investment in your home. This means that being unable to pay a personal debt—one, for example, based on a promissory note that's not secured by your home—won't automatically put you at risk of losing your home. By comparison, however, if you pledge your house as security for a loan, these homestead laws won't protect you.

Caution!

Check the law in your state. In many states, the homestead exemption is low—or even nonexistent. This means that if an unsecured creditor sues and gets a judgment, the creditor could possibly force the sale of your home to collect.

So much for the law. In the cold world of trying to raise money for your business, you might have no practical alternative to putting your home at risk. The truth is that the equity in your home might be your most accessible source of cash. The point is to ponder seriously what you and your family would do if you lost your home due to the failure of your business.

Caution!

Be careful in using a home equity line of credit to finance your business. A home equity line of credit, of course, amounts to a second mortgage. Don't overlook the fact that if you write a \$15,000 check against your line of credit to cover business expenses and can't later make your payments on time, the bank can enforce its lien rights and force the sale of your home.

Maintain Adequate Insurance

You never know when an injured person might sue your business, claiming that you or an employee acted negligently—for example, a customer who falls in your parking lot and fractures her hip might claim that you were negligent in not keeping the area properly lighted. A jury might agree that you were negligent and sock your business with a huge judgment. There are many other risks as well—such as an injured consumer suing your manufacturing business for producing a defective product or a suit by a pedestrian injured by one of your employees who was driving a company truck. In short, you absolutely need to carry adequate insurance because if you don't, your investment in the business could be wiped out by a huge verdict. Even if your personal funds or house aren't at risk, you'll have suffered a stunning financial loss.

If you're a sole proprietor or partner, be especially careful to carry adequate business risk insurance, because you're personally liable for paying the judgment. Another way to say this is if insurance proves too expensive or difficult to get, you'll almost certainly want to form a corporation or an LLC to at least limit your personal liability. (For more on insurance, see Chapter 2 of course 82651A.)

MANAGING THE FINANCIALLY TROUBLED BUSINESS

So far, this chapter has reviewed things you can do in advance to limit potential liability. Now let's shift gears and assume your business is currently facing financial problems. Our focus here is to present several practical strategies that will help legally protect both you and your personal assets.

Keep Taxes Current

Rule number one for the owner of any struggling business is to meticulously pay on time all taxes withheld from employees' paychecks. Even if you operate your business as a corporation or an LLC, the IRS and state tax authorities can hold you personally liable for these taxes—plus penalties—if they're not paid. And you're still legally on the hook to pay these taxes, even if the business goes bankrupt.

So if your business starts having financial problems, stave off the other creditors as best you can—and use whatever cash is available to take care of employment taxes. Paying these taxes is so crucial that if your business is financially disorganized, you should pay for any accounting help you need to be sure these taxes are computed accurately and paid on time.

And remember that you don't have to wait until the last day to deposit employment taxes. It's often wise to deposit the employment taxes as soon as you know the figures, so the money will be out of your bank account and legitimately beyond the reach of any other creditor who is attempting to collect a court judgment against your business.

Caution!

Don't pay employment taxes with a credit card. If possible, use a check or cash to pay employment taxes to ensure that the taxes are really paid. By contrast, if you use your personal credit card and can't pay the bill later, you'll continue to be responsible to the credit card company for the amount you charged for taxes—even if you go through personal bankruptcy. A discharge in bankruptcy won't cancel your personal liability for the portion of your credit card debt that's attributable to the tax payments.

Don't Lie About Debts

When a business starts to have financial troubles, its owner might frantically try to borrow more money. Before doing this, think carefully about whether your business is really likely to do better in the near future or if you're only likely to compound your debt problems. If you apply for a new loan or to consolidate old ones, be forthright in disclosing the financial condition of your business. If you misrepresent your debts to get a loan, you might not be able to get rid of your personal liability for the debt—even if you go through bankruptcy—because the law will regard your new debt as being obtained by fraud. Where big bucks are involved, the debt could haunt you for many years.

The key to avoiding trouble with lenders is to be very careful that all facts appear—and appear accurately—on any financial statement you give a potential creditor. Even if you borrow money or have credit extended to you without having to fill out a financial statement, it can be treated as fraud if you knew that the business was having financial trouble and didn't make all the facts clear to your creditor before obtaining the loan.

Caution!

Don't rely on shortcuts suggested by the lender's agent. Some finance company employees have been known to deliberately tell people—orally, of course—that they don't need to list all their debts. Often this is done because the person in the finance company office is under pressure to make loans and, therefore, has a motive to bend the rules to qualify you. Don't fall for this. If you later default on the loan and the company claims you obtained the money by fraudulently withholding information about your finances, chances are the employee either will be long gone or will say, "Of course I didn't say to deliberately omit debts." Either way, chances are you'll be unable to discharge the "fraudulent" debt in bankruptcy.

Also, be aware that the bankruptcy laws take a broad view of what constitutes fraud. Not disclosing negative financial information might be considered fraudulent even if you acted with the best of intentions.

Example

Jimmy, a sole proprietor, owns a secondhand furniture store. One day, the landlord raises the store rent by 50%. Based on past performance, Jimmy knows that with the rent increase, he'll have difficulty making a profit. Nevertheless, he decides to stay at that location because it would cost even more money to move elsewhere. At this time, he has a line of credit for \$25,000 with a local bank, of which only \$10,000 has been used. A month later, already feeling the sting of the higher rent, he draws against the additional \$15,000 and uses it to keep afloat. Because Jimmy neglected to tell the bank about the significant rent increase that put his business in a precarious financial condition, the additional draws can be considered a fraudulent use of credit and might well not be discharged in bankruptcy. If the bank sues Jimmy in bankruptcy court after he's gone through bankruptcy, Jimmy might still be liable for the \$15,000.

This doesn't mean that drawing on a line of credit to meet the ordinary ebb and flow of business constitutes fraud. It doesn't. After all, the bank expects that you'll use your line of credit to cover leaner times. But you do need to disclose significant changes in your business, such as a lawsuit or the bankruptcy of your largest customer that threatens the financial well-being of your business.