

LAWYERS ARE DOCTORS, TOO^{©1}

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“Lawyers Are Doctors, Too”—this title of an American Bar Association Journal article² caught the eye of this debt-restructuring law firm. While the article discussed the fact that like doctors, lawyers have a doctorate degree, the message communicated by that title should be communicated to businesses and individuals experiencing financial pressures. If the public viewed debt restructuring lawyers as doctors, they might be able to avoid economic disaster with a “financial check-up.” For decades, we have counseled small businesses in the financial arena and are continually discouraged by the volume of businesses that do not seek debt counseling advice early enough and are “dead on arrival” at our doorstep. In the financial context, this means that through a series of self-imposed “band-aids”, the client has left itself no alternative but to close its doors and has lost any viable opportunity to accomplish a work-out of its indebtedness via a debt restructuring. Such “band-aids” in most instances treat symptoms, and cause the business to avoid diagnosing the financial disease and pursuing a cure. “Band-aids”, adhered without regard to an overall “cure” or master plan, as in the medical field, can result in the eventual death of the business. Often, this “death” includes a dead-on-arrival bankruptcy filing.

Discussed below are the most common band-aids many businesses make in an effort to resolve financial tension without a financial check-up.

1. Failure to accurately diagnose the cause of the financial crisis.

Is the cause of the financial problem controllable (e.g., the embezzling bookkeeper) or out of the business’ control (e.g., a function of a down-turn in the market, such as the depressed price of the product being sold/manufactured or the increased cost of an essential product/service necessary to conduct the business)? The former may be explained to creditors and alleviated with negotiation. The latter may result in good money being thrown after bad, a failure to realistically evaluate the future viability of the business, and a lost opportunity to maximize the value of the business.

2. Borrowing operating capital from the IRS

Many financially challenged businesses will simply pay the net payroll to its employees and “hope” cash flow will increase before its periodic tax returns/remittances are due. This band-aid comes with significant penalties, interest and personal liability for responsible officers of the

¹ This article is a service for friends and clients of DelCotto Law Group PLLC. The opinions expressed in this article are intended for general guidance only and not as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance.

² Maher, Kathleen, ABA Journal, November 2006.

company. Moreover, if bankruptcy cannot be avoided, payroll and sales taxes are subject to rigid repayment provisions under the Bankruptcy Code and most cannot be discharged or released through a bankruptcy.

3. Utilizing cash advances from personal credit cards to fund the business operations.

This band-aid results in the co-mingling of business debt/personal consumer debt and now there are two legal entities that need help – the corporate business and the individual credit card holder. Many people believe if they use the card advances for the business, it becomes a business debt. In reality, the liability on the card remains with the individual.

4. Failure to communicate early and honestly with the secured lender.

Most small businesses have a major secured lender who may hold mortgages and liens on real estate and equipment (term loans) as well as operating lines of credit. These liens give the lender the right to foreclose on the property and sell the business assets upon the default of the borrower. This notwithstanding, the lender does not want to own or liquidate the business—it wants its loan repaid. Early communications with the Bank when facing financial pressure can result in loan restructuring options, forbearance or other debt relief. Waiting too long or providing less than accurate information to the Bank will significantly limit its ability and/or willingness to work with the business. Often, the imposition of a default interest rate, late fees, penalties and payment terms can be negotiated if a master plan is presented to the Bank which illustrates that the Bank can maximize its potential for recovery on the loan by granting certain concessions and avoid the closure and/or bankruptcy of the business (and perhaps its owners).

5. Failure to properly allocate available cash.

A corollary to Point 2 above (borrowing from the IRS), many financially pressured businesses will opt to repay a long-time loyal vendor or family member from available cash rather than pay taxes or the secured lender. As the saying goes, “Cash is King” when cash flow becomes tight. While appealing in some respects, applying this band-aid may have just bought the vendor or family member a lawsuit. Both state and bankruptcy law provide that payments which “prefer” certain creditors or insiders may be avoided through litigation. Moreover, both the IRS and secured lenders have rights superior to general trade creditors and these payments, without communication with the secured lender, can likewise limit the lender’s willingness to engage in a debt restructuring. Proper counsel may avoid this result.

6. Failure to accurately define the “success” of the business.

We have provided services to many clients who thought their businesses were viable because the business’ gross sales exceeded one million dollars. Many of these clients, however, do not have accurate financial statements or a budget delineating fixed and variable expenses; thus, they are unaware of their net profit margin (if any) or the amount of net income available to service debt. The preparation of an accurate budget (excluding debt service) can be a valuable

tool in assessing available funds for restructured debt service, and whether the business is truly viable.

7. Failure to acknowledge the true value of the business assets.

Directly related to the failure to prepare a budget, many businesses present the value of assets in compliance with applicable accounting standards, but when financial challenges strike, fail to assess the true market value of the assets. For example, accounts receivable may be on the books at \$100,000, but if half of that is over 120 days old or otherwise uncollectible, the value of the accounts receivable is probably significantly less. Analyzing what the creditors may actually receive from a liquidation can likewise be a strong restructuring tool, facilitating negotiations with creditors to avoid bankruptcy.

8. Searching for cash in all the wrong places.

Without a realistic restructure or workout exit strategy, business owners who obtain additional operating cash by granting mortgages on their principal residence (or allowing a spouse unrelated to the business to co-sign a new loan) significantly jeopardize their personal equity (or marital) structure. Obtaining cash this way introduces another legal entity (the business owner) who has put personal assets at risk, jeopardizing his/her personal financial structure, the recovery of which is now dependent on the success (or cure) of the business' financial disease.

9. Failing to understand the benefit of a financial check-up.

Finally, the failure of a business to understand the benefit of early and regular financial check-ups and to seek professional advice (as opposed to war stories from other business owners) hurts a financially challenged business. Many believe that the mere consultation with a debt restructuring lawyer signals a failure and a decision to file bankruptcy. Following consultation, we hear all too often that clients “wish they had come in sooner for advice.”

Self-imposed “band-aids” do not, in most instances, cure the disease—more than symptoms must be treated in a financial crisis. Most people would not think twice about going to a doctor if they had a medical symptom. Businesses should likewise pursue professional attention when adverse financial symptoms present themselves. Lawyers are doctors, too.