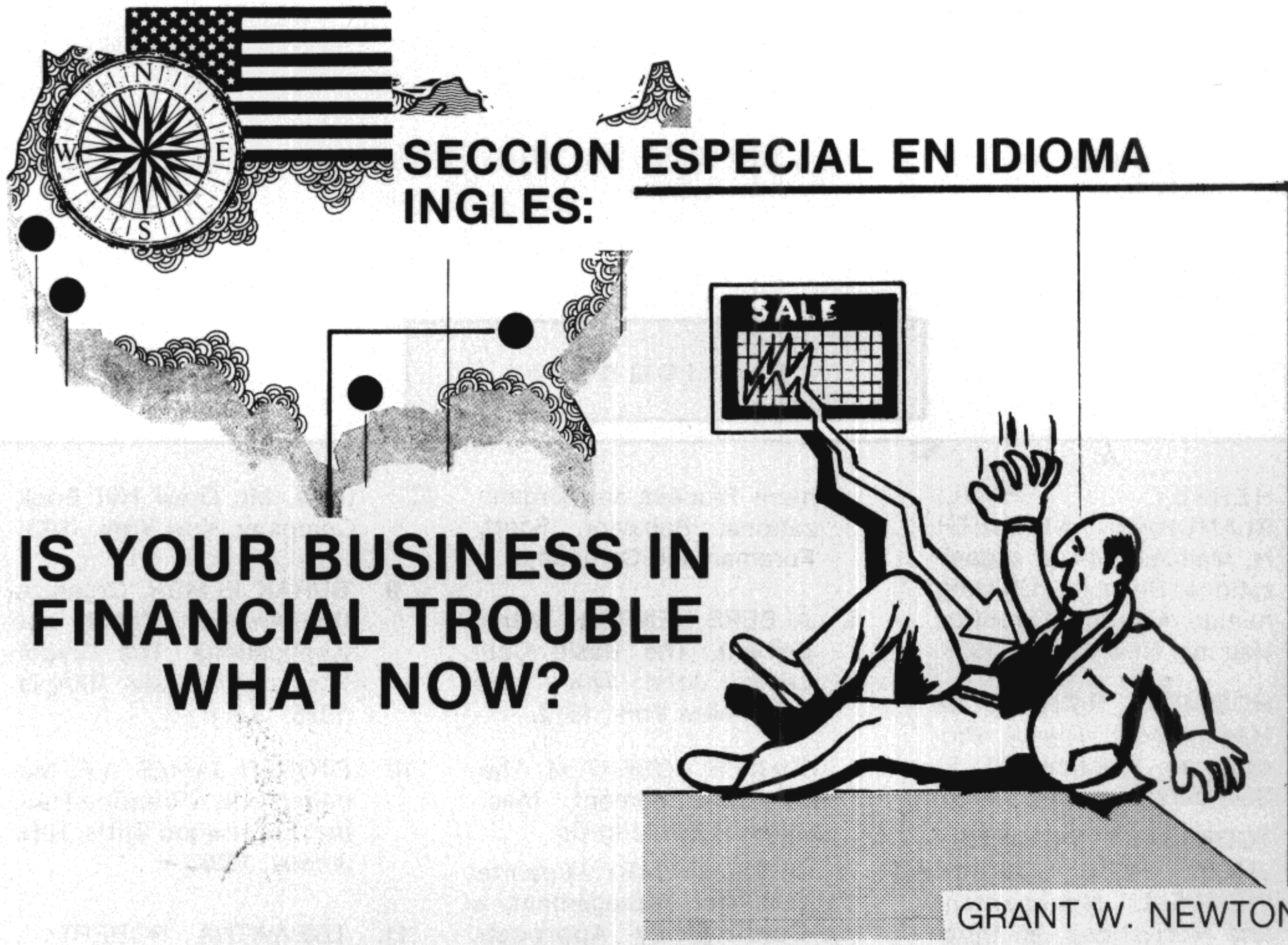
## SECCION ESPECIAL EN IDIOMA INGLES:




# IS YOUR BUSINESS IN FINANCIAL TROUBLE WHAT NOW?

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*In the financial difficulties of a failing business cannot be reversed, then immediate steps must be taken to select the best course of action for mitigating the loss.*

Every business venture expects to be successful, yet the fact remains that many will survive for less than five years. In a free economic system business failures are going to occur. It has been estimated that one out of every five Americans has been involved in bankruptcy proceedings as a bankrupt or a creditor, or is acquainted whith someone who has become bankrupt.[1]

At one time it was believed that small businesses accounted for nearly all business failures. However, within the last 10 years there has been a major increase in the number of large businesses that are having financial problems. Dun & Bradstreet reports that the average liability per failure of

1. David T. Stanley et al., Bankruptcy: Problems, Process, Reform (Washington, D.C.: The Brookings institution, 1971), p. 1.

the type of businesses which are covered in their Reference Book has increased from $97,654 in 1968 to $383.150 in 1975

While it may be true that more larger businesses are having financial difficulty, it is not true that it is easier today for the small business to survive. In fact, because of inflation, burdensome taxes, and government regulations and reporting requirements, the small business finds the going quite rough. The Small Business Administration estimates that small businesses account for over 55 per cent of the domestic employment and 43 per cent of the gross national product.[2] Financial difficulty for many of these businesses is a common occurrence. The objective of the article is to examine some of the alternatives available to a business that faces a possible failure.

## Importance of Early Action

A business has operated succesfully for several years. Suddenly it is in financial difficulty. The owner makes several attempts to correct the problems, but without success. Finally, it reaches the point where the bank note is past due, the checking account is overdrawn, and the landlord has started eviction proceedings.

Conditions similar to these are all too prevalent in business failures and it is a point in the business operation that should not be reached. No one benefits from a business deteriorating to the point where it is almost impossible to work any type of arrangement with creditors, either in bankruptcy proceeding or out of court. Liquidation of the business is often the only alternative, where the creditor receives only a few cents for each dollar of debt outstanding and the owner gets nothing. Advanced planning on the part of the debtor would have benefited all parties.

When a financial problem appears, immediate steps should be taken to deal with it. If the trend cannot be reversed, the debtor should begin evaluating alternatives for mitigating the loss. No matter what option is selected, proper planning can make the process far more financially beneficial for the debtor and its creditors.

2. Philip Revzin, "Small Business Expects President Carter, as an Exentrepreneur, to Press Its Cause," Wall Street Journal January 27, 1977, p. 32.

Before a business can be rehabilitated, it is necessary to have some understanding of the cause or causes of the difficulty. Identification of the cause is often defficult, since there may be a combination of factors producing the end results. Symptoms of financial difficulty must not be confused whith the cause.

Frequent cash shortages indicates that a financial problem exists, but it is not the source of the problem. The real problem many be lagging sales because of an inferior product or excessive costs due to inadequate equipment. Borrowing more money is not the solution. The cause of the problem must be ascertained and corected. Additional funds can then be acquired with some assurance that the shortage will not develop again in the near future.

There are innumerable causes of financial difficulty. However, Dun & Bradstreet has consistently reported in their **Failure Record**, issued annually, that over 90 per cent of failures they examine are caused by inexperience or incompetence on the part of management. This being true, it may be very difficult for the existing management to effectively assess their operations and determine the real cause of financial difficulty. Thus, it is often advantageous for these companies to bring in new management or to seek outside assistance from accountants or business management consultants.

Having identified the problem, immediate corrective action must be taken. Ideally, the debtor would like to be in a position to take the necessary steps to correct the cause of financial difficulty, obtain new financing, and continue operations without having to meet with creditors. If additional financing cannot be obtained, that normally leaves one of four courses of action. (1) Do nothing, (2) find a healthy company to acquire the business, (3) seek agreement with creditors, or (4) liquidate the business.

## Do Nothing

The most commonly selected course of action for the uninformed debtor is to take no action at all. As a result, the business continues to deteriorate and the creditors eventually will pressure the debtor to take some type of action or force the debtor into bankruptcy by filing an involuntary petition. By this time, any opportunity that may have existed to save the business is lost.

The debtor's actions during the period preceding failure will be subject to the scrutiny of the court. Unless the debtor is very careful, acts may be committed which will prevent a discharge of the debt or may even result in criminal action. Such things as the concealment of assets, obtaining credit on the basis of false financial statements, or failure to keep adequate financial records would preclude a discharge.

If a debtor postpones action in a financial crisis she/he increases the likelihood of failure, and possibly would compound the legal consequences by some act of her/his own. However, debtors continue to follow a policy of inaction, hoping for the miracle that rarely appears.

## Sell the Business

A viable alternative for some financially troubled businesses is to locate another company willing to acquire the business. If some aspect of the debtor's operations has real future potential, and especially if there is a substantial net operating loss carryforward that can be used by the acquirer, this alternative has potential. The problem is that locating a buyer may take months and, in the debtor's predicament, this amount of time is not available.

The acquisition may occur with or without the assistance of the bankruptcy court. Under certain conditions, especially where there is a considerable amount of debt to be forgiven in the transaction, it may be necessary to work out the terms of sales agreement under the provisions of the Bankruptcy Act. Careful consideration must be given to the provision of the tax law governing the carryforward of operating losses to be sure the loss carryforward can be used.

By putting new capital into the business, eliminating the unprofitable operations, improving the manufacturing process, and correcting other aspects of the debtor's operations, profits again can be realized. With a substantial loss carriforward, future profits are retained and part of them can be used to pay the creditors, which means they will now receive more than would have been received on the liquidation of the business.

## Agreement With Creditors

The most commonly selected alternative for rehabilitating a business when it is impossible to find new financing is to seek some type of relief from the creditors. This relief can be requested by meeting with the creditors informally and attempting to get them to agree to conditions that will allow the debtor to stay in business. By filing a petition under the Bankruptcy Act, the court will assist the debtor in his rehabilitation efforts.

## Informal Debt Settlements

In recent years, the number of agreements reached out of court by a troubled debtor and its creditors has increased significantly. The agreement normally involves an extension of time for debt payment, a pro rata cash settlement, or some combination of both. The informal agreement process usually is initiated when the debtor, through counsel of a local trade association, calls an informal meeting with its creditors to discuss the financial problems. At this first meeting, the debtor will make a general statement about the cause of the financial difficulty, discuss the value of the assets, and attempt to convince the creditors they would receive more if the business were allowed to continue rather than be liquidated. If the debtor has had time to compose a suggested plan of settlement, it may be advisable to present it at this meeting.

If the creditors determine that the debtor is honest and the prospects for rehabilitation of the business are good, a committee will be selected by the creditors to serve as the bargaining agent for the creditors and to supervise the debtor's operations during the time a plan of settlement is being negotiated. The committee normally will engage an independent accountant who will perform an audit and study the audit results before recommending the creditors approve the plan of settlement.

A few reasons why a out-of-court settlement is used are summarized below:

1. The out-of-court settlement is less disruptive to a business whicch continues operation.
2. The debtor can receive considerable benefits from the advice of a committee, especially if some of the committee members are businessmen, preferably but not necessarily in the same line of business.
3. The informal settlement avoids invoking the Bankruptcy Act and, as a result, more businesslike solutions can be adopted.
4. Frustrations and delays are minimized, since problems can be resolved properly and informally without the need for court hearings.
5. An agreement usually can be reached much faster informally than in

court proceedings.

6. The costs of administration usually are less in an out-of-court settlement than in a formal arrangement or reorganization.

The weaknesses of informal composition settlements are as follows:

1. A successful plan of settlement requires the approval of substantially all creditors, and it may be difficult to persuade distant creditors to accept a settlement that calls for payment of less than 100 per cent.

2. The assets of the debtor are subject to attack while a settlement is pending. (The debtor can, of course, point out to the creditor that if legal action is taken, a petition of bankruptcy will have to be filed.)

3. The informal composition settlement does not provide a method to resolve individual disputes between the debtor and the creditors.

4. Executory contracts, especially leases, may be difficult to avoid.

5. A gain due to debt forgiveness may reduce the operating loss carried forward, whereas the amount of debt canceled in bankruptcy is not taxable.[3]

## Under the Bankruptcy Act

Provisions under the Bankruptcy Act allow the debtor to work out some type of arrangements with the creditors, while the business is under the control of the courts, so that the debtor will continue in business and avoid liquidation. The most commonly known chapter provisions are Chapter X, dealing with corporate reorganizations, and Chapter XI, arrangement proceedings. In recent years, especially in California, Chapter XII, dealing with secured liens on real property, has been used more frequently.

## Chapter XI — Arrangements

Chapter XI arrangement proceedings can be used by a corporation, an individual, or partnership. The filing of the petition must be initiated by the debtor. This allows the debtor to select the most appropriate time to file the petition and to petition the court for permission to operate the business as debtor-in-possession before the creditors can take any type of action.

3. Grant W. Newton, "The Practitioner's Role in Debt Settlements," Journal of Accounting, May, 1976, p. 60.

Shortly after the petition is filed a meeting of the creditors will be called. At this meeting the debtor will be questioned and a creditors' committee will be selected. This committee has the authority to examine the conduct of the debtor's affairs, to study the plan of arrangement, to see that it is in the best interest of the creditors and to actually negotiate with the debtor the terms of the arrangement. The committee then recommends to the other creditors whether the plan should or should not be accepted.

The creditors' committee has an important role in Chapter XI proceedings. They are, in fact, the watchdog for the debtor's operations and must be sure that proper controls are in effect to prevent the debtor's assets from dissipating even further.

The debtor, while continuing to operate the business will prepare a plan of arrangement to submit to the court and also to the creditors' committee. The plan, which deals only with unsecured debt, can provide for an extension of time for payment of debts, a composition of the debts, or some combination of both.

The plan must provide for the payment of priority debts in full unless such creditors agree otherwise. The plan must be accepted by a majority of each class of creditors, both in number and in amount of claims.

## Chapter X — Reorganization

Reorganization preceedings under Chapter X are for large corporations with widely held securities and with a complicated debt structure. Relief can be sought under Chapter X only after it is determined that adequate relief could not be obtained under Chapter XI. If there are indications of major irregularities by the debtor, Chapter X may be necessary, since it provides for a more detailed review of the corporation's activities.

The petition can be filed by the debtor, or creditors of the corporation can force the debtor into bankruptcy by filing an involuntary petition. Chapter X may affect the rights of all creditors, secured and unsecured, and stockholders. If the debtor is insolvent, the stockholders are not a party to the proceedings and they may lose their entire interest in the debtor corporation.

Chapter X preceedings are much more formal than Chapter XI and are more time consuming. Most debtors would prefer, if at all possible, to reach an agreement with creditors under Chapter XI, especially if they are insolvent, because under Chapter X the stockholders may lose all of their interest in the corporation. In recent years, many large corporations have found the provisions of Chapter XI more appropriate for their needs.

## Chapter XII

Chapter XII is designed specifically to aid unincorporated real estate firms in working out financial agreements with their creditors. As a result of the 1975 changes in the Bankruptcy Rules, the debtor is allowed to retain ownership of its property and, in many cases, can operate as debtor-in-possession while a plan of reorganization is developed. Unlike Chapter XI, the creditors in Chapter XII are able to submit a plan of their own design. Two-thirds of the creditors of each class must still agree on any plan submitted. If the creditors fail to agree on a solution, the bankruptcy judge can impose one.

In fiscal 1976, the number of Chapter XII petitions increased by 87 per cent over the previous year. Twentysix per cent of the 1976 filings were by businesses in California.

Proceedings under the Bankruptcy Act offer advantages to both the creditors and debtor which make it preferable to seck relief through the courts in some situations. Some of these desirable features are:

1. The debtors are in the custody of the court and are free from attack.
2. Any gain from debt forgiveness is not taxable to the debtor and the requirement for the reduction of basis, due to the gain not being taxed, cannot result in any asset being reduced below its fair value. Under an informal settlement, the gain is taxable to the extent the debtor is solvent after the forgiveness.
3. The plan requires only mejority approval in number and amount of claims in Chapter XI and only two-thirds in amount under Chapter X for a plan allowing the debtor to continue to be accepted. By contrast, in out-of-court proceedings one creditor can prevent the settlement from being carried out.
4. The creditor has more opportunity and authority to investigate the activities of the debtor in bankruptcy proceedings, especially under a Chapter X petition.
5. The Bankruptcy Act provides for the cancellation of executory contracts, whereas a debtor with a burdensome lease may find it difficult to cancel the lease in an out-of-court settlement.
6. The bankruptcy court has the power to issue certificates of indebtedness which have priority over pre-bankruptcy unsecured debts. It may be difficult to obtain additional funds in an out-of-court settlement without giv-

ing security, because all of the creditors must agree to subordinate their claims to the new creditors.

The major disadvantages of proceedings under the Bankruptcy Act are that they are time-consuming, especially under Chapter X, and costly. If some type of agreement can be made out of court, the debtor is under less strain and can devote more effort to the business, which can result in larger dividends for the creditors.

## Liquidation

If the debtor decides that it is best to liquidate the business and use proceeds to satisfy creditors' claims, there are two alternatives which will allow liquidation to occur in an orderly manner. One is to make an assignment for the benefit of creditors under state law, and the other is to file a straight bankruptcy petition.

## Assignment

Under an assignment for the benefit of creditors, the debtor transfers the assets of the business to an assignee, who sells the assets and distributes the proceeds among the creditors on a pro rata basis. In order for an assignment to be successful, all of the creditors must give their consent, or at least they must refrain from filing an involuntary petition. Marking a general assignment for the benefit of creditors is one the acts of bankruptcy, and when an act has been committed the creditors can force the debtor into bankruptcy by filing an involuntary petition. This, of course, eliminates the use of an assignment as a means to liquidate the business. If the creditors do not file the petition within four months, the assignment is binding on all parties.

## Straight Bankruptcy

The object of this provision of the Bankruptcy Act is to convert the assets of the debtor into cash and distribute it among the creditors, thus allowing an honest debtor to start again without the burdens from business misfortunes.

An involuntary petition also may be filed against a debtor, providing he owes more than $1,000 and within four months has committed at least one of the six acts of bankruptcy. Shortly after the petition is filed, the creditors will meet to examine the activities of the debtor, to select a trustee, and to appoint a committee to work with the trustee in liquidating the business. The trustee is responsible for selling the assets of the bankrupt and distributing the proceeds to the creditors according to priority set forth in the Bankruptcy Act. If assets are available after all creditors, including the unsecured creditors, are paid, the balance will go to the stockholders. After all assets are distributed, the debtor can then be granted a discharge upon application.

An assignment for the benefit of creditors is quicker and less expensive than straight bankruptcy proceedings. The self-image of the debtor suffers less in assignments, because the stigma associated with bankruptcy is avoided to some extent. If, however, certain preferences must be set aside, or liens avoided, or the creditors are not willing to agree to any assignment, a bankruptcy petition must be filed. If fraud or other irregularities are suspected, the creditors will normallly insist that bankruptcy proceedings be commenced so that a complete investigation can be made of the debtor's activities.

## Conclusion

The alternative which should be selected by the financially troubled debtor depends on many factors. Among these are the prospects for future profitable operations, tax factors, size of company, nature of debt (secured or unsecured and public or private), number of share-holders, prior relations with creditors, extent to which the business was allowed to deteriorate, and the attitude and behavior of the debtor.

For businesses that desire to avoid liquidation, it generally helps if they give consideration to the following:

1. **Stay honest:** As long as things are going well it is easy to remain honest, but when adversity comes there is a temptation to commit dishonest and questionable acts. One of the first questions the creditors' committee asks the accountant that performed the audit is, "Are we dealing with an honest debtor?" If the answer is "No" the committee can, and frequently does, make it difficult for the debtor to reach any type of agreement in or out of court. The debtor should be careful not to commit acts that might prevent a discharge.
2. **Maintain a good relationship with creditors:** While it may be difficult to deal with the creditors during times of financial trouble, the debtor should keep the creditors informed as much as possible, deal with them honestly, and try to avoid making a large number of preferential payments.
3. **Seek professional advice:** To effectively assist the debtor, accountants and attorneys with prior experience in and knowledge of insolvency and bankruptcy should be consulted.
4. **Take early action:** Do not allow the loss to accumulate to the point where it is impossible to correct the problem.