Before Your Business Goes Bankrupt

By: Alan Gassman

I spoke on The CPAs Guide to Bankruptcy and joined a panel on "Planning Strategies for Distressed Businesses" at the annual AICPA ENGAGE Convention in Las Vegas a few weeks ago.

Co-Presenter Kenneth DeGraw, CPA, and I discussed the following ten important strategies for CPAs who have business clients who are or may become insolvent:

1. **Understand the basics of bankruptcy.** Once you file for bankruptcy, nothing is private anymore. Everything is exposed. There is plenty of infrastructure in the bankruptcy world to investigate every case. Moreover, with every bankruptcy can come terrible publicity, high emotional cost, and significant paperwork. While there are notable advantages to declaring bankruptcy (e.g., if you file a Chapter 11 Bankruptcy, you can get out of a lease), it can often be more advantageous to avoid bankruptcy when possible. There are several different ways to file bankruptcy and each alternative offers certain advantages depending on the circumstances of who is filing.

    - Chapter 7 Bankruptcies involve the dissolution of the company, and essentially handing the keys over to the Court. A trustee is appointed that will liquidate the company's assets to pay any outstanding creditors.
    - Chapter 11 Bankruptcies are more akin to reorganization than the finality of a Chapter 7 Bankruptcy. The Chapter 11 method has been increasingly frequent among large retailers, as a result of the Covid pandemic. Chapter 11 Bankruptcies are extremely expensive and can be massively time-consuming (sometimes several years). As a result of these two heavy costs, most small and mid-sized businesses will not survive a reorganization.
    - Chapter 11 is used by business entities, as opposed to the following two strategies, which are intended for personal bankruptcy.
    - Chapter 13 Bankruptcy is an individual reorganization plan designed to restructure debt repayment plants in installments to creditors over three to five years.
    - Chapter 12 Bankruptcy is specifically catered for family farmers or family fishermen. This approach is similar to a Chapter 13 reorganizational bankruptcy, but is particularly generous towards debtors, considering the additional eligibility requirements (e.g., must be engaged in farming or commercial fishing, fall under the total debt limit, and derive the majority of their income from said farming or commercial fishing).

2. **Find your client the right attorney or attorneys.** You don't have to file bankruptcy just because you consult an attorney. In fact, attorneys can often be crucial in avoiding bankruptcy. In addition to attorneys, business advisors can often make the potentially complicated bankruptcy as smooth as possible for the debtor or the business. While the process of hiring various goods, bankruptcy attorneys can become expensive, it is unwise to cut corners and settle for inferior attorneys or CPAs. Even if a client just needs a Chapter 7 Bankruptcy, it is a wise practice to direct clients to a competent, Chapter 11 experienced, bankruptcy attorney, to help design the bankruptcy.

3. **Plan for insolvency well before the problem happens, both for tax and bankruptcy purposes.** An efficient and thoughtful organization of assets, liabilities, and business entities can make a world of difference if insolvency becomes inevitable. For example, consolidating secured debts as unsecured debts can help safeguard secured collateral. The debtor will have to take extra care to ensure that no transferring of assets prior to filing is deemed by a Bankruptcy Court to be a fraudulent transfer to frustrate creditors, as those transfers can be reversed. Any transactions completed by the creditor prior to filing will be scrutinized by a bankruptcy trustee to determine if there has been a fraudulent transfer. All credit transactions that occurred up to six months before the filing will be reviewed, as well as any other sizable purchases for as far back as four years or sometimes longer prior to filing.

4. **Do not sign any compromise or extension with the bank because you could potentially sign away the right to the automatic stay.** An automatic injunction halts any actions by creditors trying to collect debts. This stay of the collection begins when the original bankruptcy petition is filed. Certain creditors (most commonly secured creditors – such as home mortgage holders) can petition the court for relief from the stay. Bankruptcy settlements will often include clauses that give up the right to an automatic stay. Most loan agreements will include language that says that they are not subject to the automatic stay. While this language is typically unenforceable, it will become enforceable if the debtor client signs something called a forbearance agreement.

5. **Be careful when deciding what attorney will handle the bankruptcy.** Get your client a personal attorney, not a corporate attorney, to maintain the attorney-client privilege and decide who you are working for. In Chapter 7 Corporate Bankruptcy, there is no attorney-client privilege. On the other hand, if the lawyer your client hires only represents your client individually and does not assist them in making a transfer to avoid other creditors, then the attorney-client privilege is preserved. Advisors should know that when a corporation files a Chapter 7 bankruptcy, the attorney-client privilege belongs to the Chapter 7 trustee. The Trustee can then depose the lawyer who was advising the company and gain access to all of the lawyer's files.

6. **Consider whether you should work under a Kovel letter.** Attorney-client privilege just doesn't exist for CPAs in bankruptcy. While some states will not admit privileged correspondence with CPAs in their respective state courts, this does not apply in a federal court. A Kovel letter is used to provide client confidentiality for complex accounting situations so that the accountant can relay technical issues to the client's attorney. Consequently, a forensic accountant may want to wait until an attorney is hired, so that all

correspondence can be forwarded through the attorney to protect any information under the attorney-client privilege and work product rule.

7. **Before the problem, have plenty of friendly debt in place.** Loan money to your company, be the biggest creditor and have a lien against its assets to enforce the debt. Setting up a new parent S-corporation and have the operating company owned by the new parent company which then becomes a QSA that is income tax-free under IRC section 368(a)(1)(f). The QSA is able to continue using the taxpayer identification number, name, and the Medicare number of the original entity. The parent company takes over all the tax characteristics of the private entity and now can have a promissory note secured by a security agreement from the original entity. Often, the ability to reorganize assets among subsidiaries and move long-term accounts receivables out of the insolvent entity is enough to deter plaintiff lawyers from rejecting a settlement.

8. **Set up a storefront company or a lifeboat company.** So if your company has to file bankruptcy, your customers can go to the other company and you won't have to advertise that you are a debtor in possession, necessarily. Client perception can be vital to maintain operations through a reorganizational bankruptcy. Having a backup company that can seamlessly continue operations in the event of bankruptcy can make the difference in calming the concerns of clients.

9. **Keep cars and drivers separate from the company that has the most value.** It is common in practice to see a lot of car accidents, which can often end up being extremely costly. Setting up a subsidiary LLC, which then buys all of the company vehicles can help limit any potential accident liability to the subsidiary which owns the vehicles.

10. **Make sure to understand how the Doctrine of Successor Liability works.** In most states, if following an assignment for the benefit of creditors, if the resulting business is substantially similar to its predecessor company (i.e., same clients, same employees, same location) then the Court has the discretion to extend the Doctrine of Successor Liability so that the creditors may continue to pursue their judgments against the original business from the successor company. To avoid the possibility of the doctrine of successor liability applying to the debtor's company, a federal bankruptcy court should approve any sale, because pursuant to federal bankruptcy law, the creditors of the debtor company cannot reach the purchaser of a court-approved sale.

11. **Be a psychologist or send your client to one.**