BY GORDON ENG

# GOING OUT OF BUSINESS

## Practitioners need to consider the advantages of formal bankruptcy to other means of closing a business

**THE RECESSION IS TAKING A GRIM TOLL** on American small businesses. Those "with one to 19 employees, nearly all of them family run, lost 757,000 jobs from the second quarter of 2007 through the third quarter of 2008, according to figures from the Bureau of Labor Statistics…That amounts to 53 percent of all private-sector losses for a group of companies with about 20 percent of all employees."[1] As businesses are closing, owners are seeking ways to cut their financial losses and bring things to an orderly end.

How does an attorney counsel a small business owner who wants to shut the doors? Many owners have invested much of their personal wealth into their businesses, while others have relied on home equity mortgage and credit cards as the primary source of financial support. Businesses with multiple owners, in turn, face complex tax, contractual, and other legal liabilities in a closure. If family members or others closely involved with the owner have had a significant role in the business, they too may be adversely affected. These unique interests must be identified in order to develop a complete closure plan.

When an owner decides to close a small business, there is usually little cash left to make parties whole or time available to settle debts in an orderly manner. In these situations, an attorney must unequivocally convey who is the client and what services will be performed so other interested parties recognize the attorney is not acting as their lawyer.[2] The attorney must gather basic information about the business, identify issues likely to arise during the closure, and prepare to resolve them. Numerous due diligence lists are available to accomplish this; however, most infor-

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mation can be categorized by whether it relates to a business or personal asset or liability and if an issue needs immediate attention or can be resolved later.

Next, an attorney must assess with the client if the business should be 1) sold through an asset sale or corporate acquisition, 2) dissolved and assets liquidated with the proceeds paid to creditors (or allow them to foreclose on their collateral), or 3) bankrupted or an assignment made for the benefit of creditors.

## Sale of the Business

Selling a business is likely the preferable option. First, the owner may recover a higher net value for the business. This is particularly true if the owner takes certain basic housekeeping actions. Businesses are often valued based on a multiple of revenue; thus, an effort should be made to collect outstanding accounts receivable. Documenting valuable contractual relationships can also enhance value. Finally, organizing and updating the books and records will help a buyer to understand the business.

Second, the owner may be able to remain with the new company as an employee or independent contractor. With many small businesses, the owner is vital to its operations either as the primary point of contact with customers or the one with the know-how on product development or service delivery. A prospective buyer may find these relationships and knowledge essential to the future success of its company.

Third, an owner may find buyer candidates among competitors, strategic vendors, employees, and investors. In addition to asking personal contacts, the owner may place advertisements in newspapers, trade publications, or online. A business broker is also another option.[3] A sale to a party that understands the industry and may already have or can readily obtain the licenses and permits needed to operate the business may be advantageous. Employees, vendors, and customers may also benefit if they can maintain a relationship with the buyer. However, the sale of a business to a competitor presents a risk that the competitor will fail to close the purchase and instead try to steal customers or use information learned during the sales arrangements to the seller's disadvantage. A properly drafted confidentiality or nonsolicitation agreement can usually address this, but common sense protection, like disclosing the most sensitive information only when a deal is certain, should be adopted.

An attorney must also be aware that when an owner collaborates with competitors, antitrust laws may be triggered. Antitrust violations and compliance issues generally arise when the parties meet certain financial or market share thresholds. Small businesses are not usually affected,[4] but some acts—such as price-fixing agreements—constitute per se antitrust violations.[5]

When the business being sold is a corporation, limited liability company, or partnership, the deal may be structured as either a corporate acquisition or asset sale. Under the former, the buyer acquires the shareholder, member, or partner interests in the entity through a transfer of those interests or a merger.[6] While ownership changes, the entity continues to exist, and its liabilities remain intact. However, in an asset sale, identified assets (and sometimes particular liabilities) are acquired or assumed. Generally, only liabilities attached to a particular asset being acquired, such as liens, are inherited by the asset purchaser. A buyer of a distressed business is likely to prefer an asset sale because it helps reduce the potential for liability for obligations related to the business.

The deal may be structured to realize certain beneficial planning opportunities. For contracts, including leases or supply agreements, the consent of the other party is usually required to transfer that obligation. However, if the business is incorporated, a sale may be accomplished through an acquisition of ownership interests without triggering antiassignment rules.

An owner must also be aware that buyers will want certain representations and warranties. Depending on how these are drafted, including whether any remain in effect after the deal is closed, an owner could face ongoing liability. An owner may also be asked to indemnify the buyer for certain liabilities or consent to the buyer's withholding of a portion of the purchase price until exposure for a liability has passed. The owner may try to avoid liabilities by selling the business on an as-is basis; however, buyers may reject this proposal.

Unless otherwise agreed to, a sale will not relieve an owner from liability for personal guarantees given to lenders in business transactions or personal credit card or home equity loans used to finance the business. Applying cash received from a sale to these obligations is an appropriate means of alleviating some or all of these financial burdens.

If the owner assigns a contract to the buyer for which the owner has personal liability, the nonselling party must give the owner a novation in order to eliminate the owner's legal exposure.[7] This means that the nonselling party agrees that it will look solely to the owner's successor for performance under the contract. For example, if the owner leases space for the business, and the landlord consents to the buyer's assuming the lease, the owner remains liable under the lease unless the landlord expressly releases the owner from that obligation.

In a family-owned business, the owner's personal and business assets frequently are so intermingled that selling the business also affects the owner's personal finances. In the sale of a business, creditors should have an incentive to reach an accommodation that maximizes the value of the business and allows the owner to pay off debts. This may be an opportune time for the owner to negotiate with lenders and creditors to accept lesser amounts as payment in full. This step, however, may not be available for other liabilities.

## Employees

Employee liabilities include payroll taxes, statutory notices related to layoffs, pension funds, and insurance matters. If these liabilities are not addressed appropriately, owners, officers, or directors may face liability. For example, payroll taxes withheld from employee paychecks are held in trust by the employer for the benefit of the government. Those responsible for collecting these payments on behalf of a company can face personal liability for failure to do so.[8]

When a layoff becomes effective, discharged employees must receive their final paychecks.[9] This paycheck must include all outstanding wages and vacation time accrued up to the time of discharge. In calculating amounts due, employers should review their employment manuals, employee offer letters, and employment contracts to verify the compensation rate and number of vacation days that each employee has vested on the termination date. Expense reimbursements, if any, are due in the ordinary course for such payments.[10]

The Worker Adjustment and Retraining Notification Act (WARN) also creates liabilities for employers.[11] Under federal law, as supplemented by California's stricter provisions, employers must give timely notices of mass layoffs to employees. Any owner with 75 or more full-time or part-time employees should be familiar with these statutes,[12] especially since penalties for noncompliance include paying each affected employee an amount equal to up to 60 days of back pay and benefits, daily civil penalties, and attorney's fees.[13]

In addition to employees, local government officials and the California Employment Development Department (EDD) must also receive notification.[14] An owner should expect EDD staff to visit and advise workers on their rights to unemployment insurance and, possibly, retraining programs. A silver lining in this situation is that notice of closure may cause local government leaders to attempt to find some form of assistance to

keep the business open.

While some exceptions to the 60-day notice are made for a faltering business or natural disaster, a company must still make a reasonable attempt to give notice of the layoff.[15] Since the WARN laws are not entirely clear in their breadth and scope, prudence dictates erring on the side of giving notice. Finally, if the business is being sold through a corporate acquisition, or the buyer intends to rehire the employees on substantially the same terms, notice may not be required.[16]

Small businesses sometimes provide their employees with a 401(k) pension program. An owner should plan to terminate any pension program to avoid ongoing responsibility. This will likely take significant time and effort. Although this process does not need to be completed before all employees have been discharged, officers and directors of a company should not overlook this issue, because they may have fiduciary responsibilities for the proper operation and termination of the plan.[17]

Under federal and California laws,[18] any employer with more than two employees that has a group health insurance plan must provide terminated employees covered by that plan with written notice advising them that they can keep their coverage at their own cost. However, if the company is closing and terminating all its health insurance plans, then the continuation of coverage for former employees is not required. Similarly, workers' compensation insurance should be terminated promptly in order to save costs; however, liability may extend after the business is closed due to outstanding claims.

Employees who are laid off are generally entitled to unemployment benefits. When the last paycheck is given, the employee must be provided EDD Pamphlet DE 2320,[19] which describes the employee's rights regarding filing for unemployment. With certain jobs and industries, unemployment taxes are not collected, and employees do not qualify for unemployment benefits.[20] For small businesses, the owner and family members working in the business, including children under 18,[21] are customarily excluded from coverage unless an election was filed to provide for such benefits and the appropriate payroll deductions were made. When a business is sold, these rules also apply to officers and directors who are the owners of a company.[22]

### Close the Doors

If a sale is unrealistic, the owner may lock the doors and wait and see if anyone comes to collect on business debts. If these liabilities belong solely to a corporation or LLC, the owner may not be overly concerned. Regardless, even if the owner had the foresight to form an entity, the likelihood is that the owner bears responsibility for these obligations. Owners must often give personal guarantees for business debts or use personal credit to obtain funds to operate the business.

Secured creditors, such as mortgage lenders and personal property lenders, are likely to proceed with foreclosure actions to recover their collateral. Similarly, landlords will initiate unlawful detainer actions to regain possession of leased property.

Unsecured creditors may defer taking action to avoid paying legal fees. Nevertheless, an owner must be attentive to creditors who wait to file until the applicable statute of limitations is about to expire. For an ordinary breach of contract claim, this is usually four years.[23] A creditor who obtains a judgment on a claim can enforce it for 10 years and renew it for another 10.[24] A judgment can also be recorded in county real estate records. If the debtor subsequently acquires real property in that county, a judgment lien will attach to the property's title, which will make resale difficult—if not impossible—until the judgment is settled.[25] Finally, when a judgment has been obtained, the defendant can be ordered to sit for a debtor's examination and asked about the existence and location of assets.[26]

The Uniform Fraudulent Transfer Act as adopted in California[27] not only gives creditors another collection tool but also allows them to wait years after a business has closed before acting. Under the act, a debtor who 1) transfers assets with the intent to hinder, defraud, or delay creditors or under certain circumstances did not receive reasonably equivalent value for the transaction and 2) is insolvent at the time of the transaction or would be made insolvent by the transaction may be deemed to have committed a fraudulent transfer. Creditors can unwind this transfer in order to recover assets. The statute of limitations on a fraudulent conveyance action is seven years from the date of the transfer.[28] While numerous defenses may be asserted against a fraudulent conveyance claim, an owner needs to be cognizant that when business is starting to decline, company transactions must be validated and documented in order to protect the owner and the vendors.

An owner who lacks the funds to wind up the business may be inclined to walk away. This approach, however, creates its own liabilities. For example, if employees do not receive their final paychecks, they are entitled to continued payment at their existing rate for 30 days or until they are paid. If WARN notices are not given as required, the penalty equates to 60 days of wages. If corporations and LLCs are not dissolved, the annual minimum franchise tax will continue to be assessed. These are merely examples. The owner who just walks away can expect to be confronted by not only employees, vendors, and lenders but also various federal and state agencies, including the IRS and EDD.

Therefore, the "close the doors" option should not be taken lightly. Unfortunately, an owner in financial distress will not likely be predisposed to seek the legal advice that can prevent a business closure that creates more problems than it solves.

### Judicial or Statutorily Assisted Closure

Bankruptcy is a third option for closing a business. If the business is operated as a corporation or LLC, this can be done under a chapter 7 bankruptcy, in which the company's assets are liquidated and creditors are paid off.[29] If the business is not incorporated, the owner must file for personal bankruptcy, which may require the owner's personal property to be included in the filing. Under a personal filing, the business owner may have

the option of filing under either chapter 13 or 7. The former is more likely when the business owner has a continuing source of income above the state's median income. If so, the debtor must adopt a payment plan to repay creditors over three to five years.[30]

Bankruptcy can offer debtors certain benefits. One is a single forum in which to contest the validity of creditors' claims. Another is providing a mechanism for liquidating the debtor's assets and allocating them to creditors. If the proceeds are insufficient to pay creditors in full, the balance will be discharged unless the debt relates to 1) federal, state, and local tax claims (subject to specific time rules), 2) spousal support and child support, 3) most student loans, 4) secured debts, 5) fines and penalties imposed by government agencies, 6) fraud-based claims, and 7) punitive damage claims. Further, in a personal bankruptcy, the debtor's assets are not entirely subject to liquidation to pay creditors. While California law provides for two alternative and mutually exclusive lists of personal exemptions, there are certain common exemptions, including motor vehicles (up to a certain dollar amount), professional licenses, tools of a trade (up to a certain dollar amount), and pensions and certain other retirement accounts.[31] A third benefit of bankruptcy is that a debtor can gain some breathing room, because bankruptcy law imposes an automatic stay against collection actions.[32]

On the other hand, a bankruptcy filing exposes the owner's business dealings to scrutiny. Transactions engaged in prior to the filing may be analyzed to determine if they constitute preferences, which the bankruptcy court could set aside.[33] Preferential transactions may include those between the bankrupt party and its affiliates one year prior to the filing and those between the bankrupt party and unrelated third parties within 90 days of the filing. Many exceptions exist to the preference rules. Two should be noted; one is a transaction that is a contemporaneous exchange for value, and the other is a transaction in the ordinary course of the debtor's business.[34] If a transaction is unwound, it does not automatically terminate the underlying obligation; rather, the consideration that was paid is returned, and the creditor placed in the same position as other unpaid creditors. For example, if a vendor sold a product to the business prior to its bankruptcy filing and received late payment during the applicable preference period, the vendor may be forced to return the payment to the bankruptcy estate and wait with similarly situated creditors for payment, including assuming the risk of receiving something less than the full amount owed.

Individuals and companies may also avail themselves of an alternative procedure known as an assignment for the benefit of creditors (ABC).[35] This is similar to bankruptcy but is done without formal legal proceedings. The individual or company assigns its entire assets to an assignee, who acts as a fiduciary to liquidate the assets and distribute the proceeds to creditors. The assignee has authority similar to a bankruptcy trustee, such as the power to unwind preferential payments.[36] However, unlike a bankruptcy trustee, who can be elevated to the status of a bona fide purchaser when challenging the sufficiency of security instruments held by secured creditors, an ABC assignee is generally deemed to be a successor with rights no greater than those of the assignor.[37] Moreover, an assignee does not have the power to force a sale of assets free and clear of pre-existing security interests, so the assignee must negotiate with secured lenders in order to sell encumbered assets.

The differences between an ABC and bankruptcy include 1) the assignee is selected by the company instead of appointed by the bankruptcy trustee, 2) the assignee has discretion to set fees, while trustee fees are set by statute,[38] 3) the debtor cannot seek an automatic stay, and 4) no cap is imposed on a landlord's claim for breach of a lease. Generally, an ABC is considered less expensive and faster than bankruptcy; however, if creditors do not feel the ABC is being conducted fairly, they could force an involuntary bankruptcy, which could eliminate any cost or time savings.

Once the business is closed and its assets liquidated, the owner may still need to attend to some issues. If the business was operated in a corporate form, it must be dissolved with the secretary of state. This process can be started before liquidation is commenced or deferred until disposition of all assets. Once provision has been made for any remaining creditor claims and tax obligations (including the filing of returns) have been settled, the company as a legal entity will be dissolved, and minimum franchise taxes will no longer be due.

Business owners who are shutting their doors may be reluctant to retain counsel to help with this process because of concerns over fees and fears of becoming entangled in a legal morass. Also, the legal community has often not extended itself to reach out to the small business community and be responsive to their issues. However, in this current economic environment, attorneys have a significant opportunity to demonstrate how they can assist small business owners, especially those in financial distress, and help them work through the issues of closing a business in a manner that leaves little or no financial and legal exposure. ■

In this current economic environment, attorneys have a significant opportunity to demonstrate how they can assist small business owners.

[1] Damien Cave, *Family Businesses Are Reeling in Recession,* N. Y. Times, July 13, 2009, *available at* http://www.nytimes.com/2009/07/14/us/14flag.html.

[2] *See* Responsible Citizens v. Superior Court, 16 Cal. App. 4th 1717 (1993); Johnson v. Sheppard, Mullin, Richter & Hampton, 38 Cal. App. 4th 463 (1995).

[3] A business broker may be found via the California Association of Business Brokers at http://www.cabb.org.

[4] *See* Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. §18a, requiring detailed reporting to and review by the Federal Trade Commission for deals in which the parties or the transaction is of a certain size. However, transactions under $50 million are not covered, which should exclude most small business transactions.

[5] *See* Sherman Antitrust Act, 15 U.S.C. §§1–7.

[6] *See* Sales and Mergers of California Businesses (CEB 2009).

[7] Civ. Code §1531.

[8] I.R.C. §6672(a).

[9] Lab. Code §201.

[10] Division of Labor Standards Enforcement, Enforcement Policies and Interpretations Manual §4.3.4, *available at* http://www.dir.ca.gov.

[11] Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§2101 *et seq.*; California supplement to WARN, LAB. CODE §§1400-08 (often referred to as Cal-Warn).
[12] LAB. CODE §1400(a).
[13] 29 U.S.C. §2104(a)(1); LAB. CODE §1402.
[14] LAB. CODE §1401.
[15] 29 U.S.C. §2102(b)2)(A) (failing business); 29 U.S.C. §2102(b)(2)(B) (unexpected sudden adverse change of circumstances). The California WARN law does not contain an exception for a sudden adverse change of circumstances.
[16] MacIsaac v. Waste Mgmt. Collection & Recycling, Inc., 134 Cal. App. 4th 1076 (2005). The applicability of the statute to a purchaser in an asset sale has been upheld in at least one case. *See* McCaffrey v. Brobeck, Phleger & Harrison, L.L.P., No. C 03-2082 CW, 2004 WL 345231 (N.D. Cal. Feb. 17, 2004).
[17] Employee Retirement Income Security Act of 1974, 29 U.S.C. §§1001-1461; *but see* 29 C.F.R. §2550 .404c-1.
[18] Consolidated Omnibus Budget Reconciliation Act (COBRA), 29 U.S.C. §§1161 *et seq.* I.R.C. §414 applies to employers who have more than 20 employees in the past year. The California Continuation Benefits Replacement Act of 1977, including Health and Safety Code §1366.20, applies to employers with two or more but less than 19 employees.
[19] *See* http://www.edd.ca.gov/pdf_pub_ctr/de2320.pdf.
[20] *See, e.g.,* UNEMP. INS. CODE §§629-657.
[21] UNEMP. INS. CODE §631.
[22] UNEMP. INS. CODE §637.
[23] CODE CIV. PROC. §337.
[24] CODE CIV. PROC. §§683.010-683.220. *See* Kertesz v. Ostrovsky, 115 Cal. App. 4th 369 (2004) (10-year period runs from issuance of the judgment and passage of applicable appeal periods).
[25] CODE CIV. PROC. §697.310.
[26] CODE CIV. PROC. §§708.110-708.205.
[27] CIV. CODE §§3439-3439.12.
[28] CIV. CODE §3439.09.
[29] *See* 11 U.S.C. §§1301 *et seq.* (chapter 13) *and* 11 U.S.C. §§701 *et seq.* (chapter 7).
[30] In general if the debtor has a certain level of financial wherewithal (income from all sources above the median income for the state, subject to deductions and adjustment), the debtor will be required to file under chapter 13, by which some secured debt can be crammed down to its fair market value and unsecured creditors are limited to net income of the debtor over the payment period. *See* 11 U.S.C. §1325.
[31] CODE CIV. PROC. §§695.060, 703.010, 704.010, 1800-1802 *et seq.*; 11 U.S.C. §522.
[32] 11 U.S.C. §362(a).
[33] 11 U.S.C. §547.
[34] 11 U.S.C. §§547(c)(1), (2).
[35] CODE CIV. PROC. §§493.010-493.060, 1800-1802.
[36] *Compare* CODE CIV. PROC. §1800 *with* 11 U.S.C. §547. However, California courts and the Ninth Circuit appear split on this issue. In *Sherwood Partners, Inc. v. Lycos, Inc.,* 394 F. 3d 1198 (9th Cir. 2005), the Ninth Circuit held that the ability of an assignee of an ABC to assert preference claims was preempted by the Bankruptcy Code. California courts disagree. Credit Managers Ass'n of Cal. v. Countrywide Home Loans, Inc., 144 Cal. App. 4th 590 (2006); Haberbush v. Cummins Family Ltd. P'ship, 138 Cal. App. 4th 1630 (2006).
[37] *Compare* Vollstedt Kerr Lumber Co. v. Production Homes, Inc., 130 Cal. App. 2d 507 (1955); Credit Managers Ass'n v. National Indep. Bus Alliance, 162 Cal. App. 3d 1166 (1984) *with* 11 U.S.C. §544. *See also* COM. CODE §§9102(52)(A) *and* 9317 (right of assignee to assert lien creditor status to challenge defective personal property liens).
[38] 11 U.S.C. §326.

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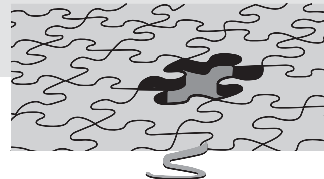
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