

2022 Consumer Practice Extravaganza

Considerations for Winding Up a Business: A Conversation with Your Client

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Laura Day DelCotto: Laura Day has practiced law for over 35 years in Kentucky – the first half of her career doing primarily secured lender and lender liability work at one of the larger Kentucky-based law firms, and the second half doing mostly chapter 11 debtor and committee work at the 6-attorney firm she co-founded in 2003, DelCotto Law Group. She is a Fellow in the American College of Bankruptcy, certified in Business Bankruptcy by the American Board of Certification, and is one of the co-founders of the Central Kentucky (now KIT) Chapter of IWIRC.

Michael T. O'Halloran: Michael has been a California insolvency lawyer for 41 years, initially as trustee's counsel, then as a debtor's attorney. He is certified as a bankruptcy specialist and is a long-time author for the Regents of the University of California CEB. He has advised on many business closures. He regularly lectures on bankruptcy and insolvency topics.



- This presentation offers ideas relevant to closing a small business.
- Not all concepts will apply in all cases.
- There are exceptions to every rule.
- This is not a recipe; the order of action depends on the case.
- THE DISCUSSION ASSUMES AN INSOLVENT BUSINESS AND OWNER. If the owner is solvent, the approach is to minimize the demands on guarantees by minimizing creditors' damages. Much tougher job.
- If the business is a partnership or has investors, there can be additional concerns. A one-owner business is the focus here.



- Be sure you clearly communicate who you represent
- · Put into writing why you cannot advise the non-client
 - Many clients have treated the business and personal finances as one.
 You have to explain why you cannot and will not do the same.
 - You probably have this talk more than once.
- · Be clear in your communications who you are advising
 - Attorneys want to help their clients, but can get into bad situations when they answer questions for non-clients
- Always document potential conflicts of interest and send CYA letters



- It is very expensive to perfectly close a business.
- It is impossible when there is not enough money.
- Management has to prioritize actions with counsel's help.
- The process will be reactive at times because creditors have rights and may enforce them.
- · Assume the worst. Act promptly.

FAILURE IS EMOTIONAL .

- Often the client is very emotional. Closure is a failure.
- Entrepreneurs are terrible at admitting defeat. They keep going to work even when the enterprise cannot be saved.
- Let the client tell you the history of the business and the cause of the collapse. It is healthy for the client to vent and it is very informative for counsel. However, you do not have to let the client repeat it at every session.
- Counsel can bring structure to the closure process and give definition to an intimidating process



- It is often bitter to wind up a business.
- Closure goes best if the emotional pitch of the parties, esp. the enemy, is not inflamed. Keep conflict minimized.
- An emotional creditor is more likely to hire counsel to do extra work. Making it easy for the creditor makes it easier for the debtor.
- It is tempting to make the closure harder on certain creditors. Emotions run high. Advise against payback.
- Counsel should encourage reasonableness, but not passivity.
- Stress the importance of documenting the liquidation of inventory/assets.



The Last Dollars should be used to make the closure as orderly and forward looking as possible.

Go ahead and pay for items that may have little utility today but will be beneficial later.

There is <u>no</u>reward for being cheap.

Seeking perfection and efficiency can be a response to being out-of-control.



- Time can be the debtor's Friend.
- Management needs to fade away so it does not get sued more than inevitable.
- SLOW PLAY ALL CREDITOR RESPONSE. Being out of business means not caring about Yelp reviews. Take a week to reply to emails about debt. Let all calls go to voicemail; consider a reply by email. Call back after business hours to avoid fruitless discussions.
- Be bleak in messaging. <u>Say nothing hopeful.</u> The saying "Hope springs eternal" is true.
- If asked, don't give a name. Ignore the question.

MANAGEMENT CAN TAKE SALARY

State law can allow management to be paid a modest salary for services in the Final Days. *Annod Corp. v Hamilton & Samuels*, 100 Cal.App. 4th 1286 (2002).

BE REASONABLE. Don't catch up on missed salary.

Many managers quit taking salary toward the end. This is not dictated by law.

Note: taking money as loan repayment might be a preference. Compensation is not..



- Many factors must be evaluated as to a creditor's threat.
- A threat is not credible if the creditor cannot actually fulfill its threat.
- Similarly, if the time needed to act on a threat is longer than the time needed by the debtor, the threat is less worrisome.
- Factors can include:
 - · Amount owed.
 - · Lien rights.
 - · Value recoverable by the creditor.
 - Amount of disruption caused if the threat is implemented.
 - Emotional state of the creditor.
- BUT A Writ of Attachment can tie up the process.

COMMON TIME FRAMES FOR CREDITOR ACTION

- A bank can offset immediately without notice.
- A UCC sale can be held in less than a month. Notice required. Not common in small cases.
- A landlord will need up to a month or more to evict.
- A prejudgment writ can tie up all the assets without notice.
 These are rare.
- Collection litigation will take 2-6 months to produce a default judgment from the time of lawsuit filing.
- Litigation can last 6 to 24+ months if an answer is filed.
 Answering is valuable.
- Involuntary bankruptcy filings are very very rare.
- KNOW YOUR STATE LAW AS TO THESE REMEDIES.



- FILE ALL THE FINAL TAX FORMS.
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- With the Last Dollars, prepay the CPA or bookkeeper in advance to do next year's taxes, esp. the W-2s.
- Give her\him the records NOW.
- · Huge benefits in filing even if not paying.
- · Advise if the owner is exposed to tax liability.
- Explain the federal trust fund payroll tax penalty if there are unpaid federal payroll taxes.

TAX FORMS – BETTER YOURS THAN THEIRS

- If the taxpayer does not file final returns, bad things happen.
- The government may file for the taxpayer and legally exaggerate the taxes owing.
- The government won't know the business is closed.
- The filing will start statutes of limitations running.
- THE EMPLOYEES WILL SHOW UP AT THE OWNER'S DOORSTEP NEXT SPRING AND WANT W-2s. This can get unpleasant.
- TIP: A final tax return does not mean bank accounts must be closed. If you close the account too soon and your client gets an unexpected check later, it will be hard to cash it.



- Typically, lots of records can be abandoned. THIS IS VERY INDUSTRY-SPECIFIC. Ask the client what reporting or auditing is regularly conducted. Keep all those records.
- If the records are digitized, use the Cloud and a physical device. Maybe take the server home. <u>Cloud storage can be</u> <u>costly, esp. specialized software licenses must be paid for</u> <u>access.</u>
- Keeping a printed copy is a nice backup. Old fashioned.
- If records are voluminous, use the Last Dollars to rent a storage unit. Put the file cabinets with the records there.
- Consider prepaying rent for the term of any possible audit.
- Does HIPAA apply? If yes, obey it.

LANDLORD CONCERNS: POSSESSION AND \$\$

- <u>Landlords want possession if they cannot get money.</u> If you tell the landlord that the business is closing, the landlord worries. Will the tenant damage the site? This makes the landlord act more reasonably.
- Give the landlord a firm date or target date for returning the space. No need to pay rent through that time unless it is longer than the landlord needs to evict.
- A peaceful, structured surrender should appeal to all parties. It is often achievable.
- This presumes an unpayable lease guarantee. If the guarantor is solvent, the goal is minimizing landlord damages.
- In a liquidation sale, pay the landlord something.



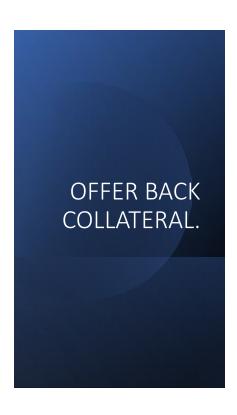
- This will make the landlord mad. Don't do it.
- Go back to law school and check out the law of fixtures.
 Landlords own fixtures. Taking them is bad. Explain what this means to your client
- Even if it is a fixture, taking gear means it takes up garage space before it is tossed. The impulse to do this should be fought. The item may be useless in real life.
- Don't worry about leaving the place perfectly clean.
- Fixtures, one definition:

(1) A fixture is an item of tangible property, the nature of which was originally personalty, but which is classified as realty because it is physically or constructively annexed to realty with the intent that it remain annexed indefinitely.

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- Giving a lien on an asset can be thought of as giving the asset to that creditor. Especially if the business is closed.
- Management cannot sell the collateral and use the proceeds freely. That money belongs to the secured creditor.
- It can be a tort to sell and use the funds other than to pay the creditor. In re Thiara, 285 B.R. 420 (9th Cir BAP 2002). This angers the creditor and raises the risk of litigation.
- Expensive collateral matters most. Low valued assets are ignored and rarely repossessed.
- Better to leave expensive items in the leasehold than sell them. Let the landlord and the creditor work it out.
- Option: put the collateral in prepaid storage for a time.
 Give the creditor the address.



- Closure is very dramatic for a secured creditor <u>until</u> it gets its collateral. After that, it is a collection case. Less drama then
- The debtor can set the time and place for repossession if there is no court order.
- Giving up collateral makes a later bankruptcy smoother because the debtor can explain where gear went and why. No motion for relief from stay will be filed. The trustee won't waste time on overencumbered property.
- Surrender can keep the emotional pitch down.
- Confirm secured status . CA UCC-1 filings may be searched here: https://bizfileonline.sos.ca.gov/search/ucc
- Today, there are lots of SBA liens securing Covid loans.



- Assume that dealers talk to the auto financiers all the time.
- The client can drive a leased or financed vehicle back to the original dealer and leave it. The vehicle will get to the finance company. Getting a surrender memorialized in writing is not usually essential.
- This is better than having vehicles disappear.
- You can pull a 50-foot powerboat into a secured creditor's parking lot and leave it for the creditor. This saves a lot on storage fees. The reaction is interesting.

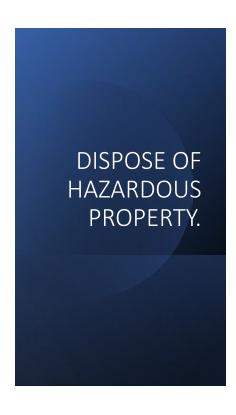


- Leasing companies hate getting gear back.
- Once you offer it to them, they stop calling.
- <u>They usually do not pick it up</u> unless it has lots of resale value.
- Giving notice reduces the threatening lessor calls. It is polite. It gives a good defense later when the lessor wants to know where the stuff went. "I called you but you did not come, so I left it."
- This can reduce stress substantially.

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LEASED GEAR – LEAVE IT BEHIND

- Leased property is not owned by the Debtor. <u>Do not sell it.</u>
- Selling leased property can be tortious and nondischargeable for an individual. But intent matters.
- State law gives the landlord procedures for removing abandoned property. The landlord wants the tenant to clean the space. Not always practical.
- Do not take the gear home. It will stay in the garage forever.
- OK to leave leased copiers in the office. Yes, the landlord might put them in the parking lot. Not the Debtor's fault.



- Try not to leave this for the landlord.
- There can be criminal exposure for abandoning hazardous materials.
- The client is usually versed in what ought to be done.
- This is a very important use of the Last Dollars.
- In a very complicated situation, considering hiring an expert to advise on how to proceed.
- Note: no landlord wants to acquire hazmat. If the landlord knows of the hazmat and the Debtor is working on removing it, the landlord will normally not seek possession until that is finished.

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MAIL GOES TO A P. O. BOX, NOT HOME With the Last Dollars, <u>rent a P.O. Box</u> for a year and send the mail there.

If it goes to the home, trouble, aka creditors, may follow.

Don't skip this. <u>Tax agencies use the US Mail</u> exclusively to tell you "You Have Trouble." Management will want to know this sooner than when the County Recorder or a credit report tells her of a tax lien.

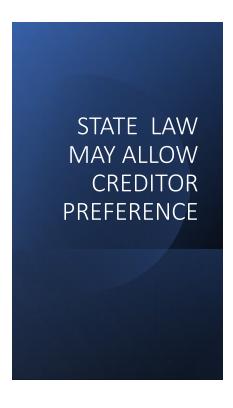


- It is hard on employees to lose a job. Be aware of possible problems.
- Watch for the X-Factor! Ex-partner, spouse, employee.
- DO NOT LET EMPLOYEES WORK WITHOUT PAY. It is illegal, amoral, dishonest, and creates criminal prosecution risks.
- Try to pay vacation and sick leave. Staff will know these amounts.
- · Assume hard feelings and bitterness.
- Appreciate that they know a lot about the business and are bad enemies.
- Work to create the softest landing possible for them. Less drama. But do not drag out the process.
- Goodwill can evaporate overnight.

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- · Collect the keys.
- Change the passwords quickly. Trust only if essential.
- Minor pilfering at the end may be inevitable. Why should management care? It is not profit-maximizing.
- If the loss of valuable assets is a risk, maybe tell the secured creditor so it can protect its interests. This may reduce Debtor's responsibility.
- Cancel the company credit cards and cell phone accounts.
- · Lock down the online banking. Beware ACH draws.



- It is the Bankruptcy Code that provides for the reversal of preference payments. 11 USC Sec. 547(b).
- To the contrary, California Civil Code Section 3432 provides that any creditor can be paid at any time. The stature was enacted in 1872. Never altered.
- The motive for the payment is relevant. It must be in good faith.
- Insider payments are suspect except in exchange for current consideration, such as payment of compensation.

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- Don't let the CPA dissolve the company quickly. It remains a shield.
- Don't make promises to employees and creditors.
- No hopeful messaging. Be bleak and dire.
- Don't try to close perfectly.
- Don't go to the bank and say there is trouble. Banks have two operational modes: calm and panicked.
- No need to tell everyone how badly this is going to hurt them because you care about them. No.
- Don't take all the Last Dollars home. Use intelligently, then share.



- If a corporate bankruptcy is to be filed, the preparation is easy.
- The questions about payments and transfers need to be considered in making decisions while closing.
- Be ready to explain where any asset went in the Final Days and have the back-up documents to prove it.
- The Statement of Financial Affairs questions about transfers and insiders call for disclosure of certain payments and transfers. What must be disclosed and the consequences may guide closure decisions.
- Remember, debtors have a duty to maintain financial records.

Faculty

Laura Day DelCotto is a founding member of DelCotto Law Group, a boutique law practice in Lexington, Ky., focusing on bankruptcies, restructurings, and various types of commercial, debtor/creditor and bankruptcy litigation. She has more than 35 years of experience in all aspects of corporate, municipal and high-net-worth individual liquidations and restructurings. The first half of her career was focused on secured lender and lender-liability work at one of the larger Kentucky-based law firms, and the second half has been focused mostly on chapter 11 debtor and committee work. Ms. DelCotto holds numerous professional recognitions and is a Fellow in the American College of Bankruptcy. She is also Board Certified in Business Bankruptcy Law by the American Board of Certification and holds top ratings in Martindale-Hubbell, and she is listed as a "Top 10" attorney in *Kentucky Super Lawyers* and in The Best Lawyers in America's "Lawyer of the Year" selections for Lexington, Ky., for Bankruptcy, Bankruptcy Litigation, Insolvency and Debtor/Creditor law. Ms. DelCotto is one of the founders of IWIRC's Central Kentucky chapter. She received her undergraduate degree *magna cum laude* from The University of the South at Sewanee and her J.D. with distinction from the University of Kentucky College of Law. She is also certified in Ayurvedic Lifestyle by the Chopra Center, and is a speaker/teacher in educational and corporate wellness programs.

Michael T. O'Halloran is the founder of The Law Offices of Michael T. O'Halloran in San Diego, where he represents debtors in complex cases. Previously, he was a trial and bankruptcy appellate panel law clerk for Hon. Herb Katz, chief bankruptcy judge for the Southern District of California, and represented trustees throughout the 1980s. Mr. O'Halloran is certified in both Business and Consumer Bankruptcy Law by the American Board of Certification and as a bankruptcy specialist by the California Board of Legal Specialization. He has twice been named Mediator of the Year by the U.S. Bankruptcy Court for the Southern District of California, received the State Bar President's Pro Bono Service Award in 2014 and was named Volunteer Lawyer of the Year by the San Diego Volunteer Lawyer Program in 2009. He is also a contributing author to *California Domestic Partnerships* and the bankruptcy chapter in the *California Basic Practice Handbook*, both published by CEB. Mr. O'Halloran graduated from the University of California in 1976 and received his J.D. from the University of Southern California Law Center in 1981.