Recognizing the Warning Signs of Financial Distress

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Through this economic downturn, it seems like every year brings a new group of businesses and individuals into financial distress. There is no magic to recognizing the warning signs of who will be in distress next. Usually, it is a matter of acknowledging the obvious. But, business owners and managers are often so focused on working their way out of a problem that they fail to recognize how bad things have become.

While this perhaps speaks well of their fighting spirit, waiting too long to address financial distress can be catastrophic. The cost of not recognizing the scope of a problem is often that the business has spent all its cash and given away important rights to its lenders. An important first step when dealing with a financially-troubled company is to understand the nature and range of possible problems. Then, we will discuss some frequent warning signs.

While every situation is unique, most business financial distress falls into one of four general categories:

Companies with Temporary Cash Flow Problems

Some businesses are profitable but are having problems paying bills on a current basis. This may be due to inadequate capitalization, aged or bad accounts receivable or higher than tolerable debt payments. As the situation worsens and bills become delinquent, trade or other creditors may withdraw credit and/or place the company on a cash-in-advance or C.O.D. basis. Some creditors may start to sue for past due balances. Secured creditors may accelerate loans and begin foreclosure proceedings. In these situations, Chapter 11 or an out-of-court restructuring may provide the temporary relief the business desperately needs, and also provide an opportunity to restructure debts to ensure future profitability.

Companies with Unprofitable Businesses Due to Management Problems

Some businesses are operating at a loss, but could be profitable if managed correctly. Management difficulties are often caused by disputes between current or former owners. If the management problem is one that can be solved, it may be necessary to find a way to stop creditors' collection efforts while the necessary business plan is formulated and implemented.

Companies with Special Problems

Stopping collection actions and having the opportunity to restructure debts may be a benefit to all financially-troubled companies, but some companies' circumstances make a bankruptcy reorganization an especially viable option. Some companies have special one-time problems such as a need to cancel unfavorable leases or other contracts, a need to avoid foreclosure or reinstate defaulted loans, or the desire to resolve costly litigation.
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Companies that Need to Continue Operating While Shutting Down

Inevitably, some companies will close. Whatever the reasons for the shut-down, it is sometimes preferable to continue running a company while effectuating an orderly closing, rather than abruptly locking the doors and walking away. To close down a company in an orderly fashion, a company often needs to: (i) maximize the value of the company’s assets; (ii) finish work-in-process; (iii) give employees time to find other employment and possibly limit employment-related claims; (iv) continue paying management salaries during the shut-down; and (v) maintain some control over the manner in which the company is liquidated and the assets distributed.

Due to the close relationships that lawyers and accountants have with their respective clients, we frequently will be among the first to see signs of financial distress. The following symptoms, while by no means exhaustive, are clues that a company is struggling.

Stressed Out Management

Stress is a fact of life for most business managers. But, when ordinary business stress is combined with the pressure of financial distress, things can get truly harrowing. Owners of struggling companies often say they feel like they are drowning. Business stress can also be a factor in health and family problems. If you notice a business client or colleague who appears uncharacteristically ragged or sick, have the courage to ask how business is going and encourage him or her to seek help if needed.

Borrowing to Cover Shortfalls

Borrowing money or injecting new capital as part of a well-reasoned business plan is usually a critical ingredient in a successful venture. But propping up a struggling business through borrowing, capital infusions, or sales of assets is a different animal. Similarly, selling assets off to pay personal taxes is a sign that the underlying business may not be self-sustaining. Knowing whether such financing options are smart investments, or simply a last gasp, requires a determination of whether the business is viable in the long term. None of us has a crystal ball, but making an informed assessment about viability can be the difference between success and disaster.

Management Infighting

Financial distress is often related to disputes among owners and managers. Sometimes financial distress is the cause, and other times the effect. When a dispute arises, an owner or manager typically will seek guidance from his or her lawyer or accountant. The client may be asking for help only with the dispute, but an astute professional will also delve into the impact on the company’s profitability.

Forbearance Agreements
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Financial distress is the inability to meet obligations as they come due. So, if a business is negotiating a forbearance agreement with its lender, some hard questions must be asked. Lenders often use forbearance agreements to obtain concessions and waivers from borrowers in default, rather than moving straight to enforcement. Even if a business client is confident it can work its way out of trouble during a forbearance period, it should always seek counsel from a restructuring professional before signing such an agreement.

Growing Payables

Nothing signals financial distress as plainly as slow-walking payables. If an accountant sees that payables are growing, or if an attorney is asked to defend collection actions (particularly if the company says it just needs to "buy time"), the subject of financial distress should be raised. Sometimes the unpaid bills are fees owed to a company's own lawyers or accountants. This can undoubtedly strain the relationship and diminish communication, but non-payment of professional fees is a fundamental warning sign of financial distress and should invite serious inquiries.

Payroll and Sales Taxes

Failure to remit payroll or sales taxes is another clear sign that a business is in trouble. Payroll withholding taxes, or 941s, are comprised of two parts. The "trust fund" portion is part of an employee's compensation that is withheld from the paycheck and remitted to the IRS by the company on the employee's behalf. The other part is the matching funds required to be paid by the company. Sales taxes are entirely trust fund taxes because the company is required to collect the taxes and remit them to the state department of revenue; the money never belongs to the company. Since trust fund taxes are not property of the business, failure to remit them to the appropriate taxing authority is a serious matter. In fact, the person responsible for collecting and remitting trust fund taxes can be assessed personally for the unpaid amount.

Financial distress can be a difficult topic to discuss. But encouraging a business client to seek help in the early stages of financial distress can greatly increase the client's chances for a return to profitability, or at the very least, for a soft landing. The best way to gather the information necessary to diagnose the important issues is to engage the business owners and/or managers in a thorough discussion. If you see any of the warning signs discussed here, do your client a favor and ask about it.