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Identifying Signs a Company Is in Financial Distress

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General counsel play a unique role in the context of a company. They must be an employee of the company while maintaining the foresight to identify issues that the management of that company might not identify, or might not want to identify. Included in this is the ability to spot the warning signs that a company could be financially distressed and the ability to determine whether to consult with outside counsel or a restructuring specialist to assess the company's financial position.

Often, general counsel may not be in the inner circle of the business with direct access to financial information or business strategies. Sometimes, general counsel may be approached by management at a late stage asking for guidance or interpretation of signs of a financially distressed situation within the company. At that point, things may have spun out of control or be so far down an awkward financial path that the company may not have many choices for resolving the difficult position it finds itself in.

While general counsel need to maintain an arm's-length view of these types of scenarios, there are signs that might signal the need to reach out to management early to suggest some ideas or steps to put into place that might avoid a more dire position for the company later on. There is no question that in difficult economic times — and when a company experiences or is entering a financially challenging, distressed situation — the early reach for outside professional assistance may smooth out the long-term path and assist in



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some type of reorganization before the situation is irreparable.

There are many things general counsel can look for to see signs of a downward turn of the company. This list is more illustrative than anything, but presents a good outline of factors to consider at an early stage. Some of these categories include:

- **The company does not timely pay creditors.**

Even something as simple as a company consistently failing to pay some creditors may be a warning sign of financial distress. It could signal that the company has determined that it

cannot timely pay all creditors and has decided that it will focus on paying essential creditors, or creditors with aggressive collection tactics, in order to continue the business while hoping that its income increases.

If a company repeatedly opts not to pay certain creditors, or consistently pays creditors less than is owed, it is a signal to general counsel that the company may need outside help.

- **The company is being sued in collection matters.**

Collection matters may be business as usual in a company's general practices. But a sudden increase in the volume of demands from collection agencies or attorneys, or an uptick in the number of filed lawsuits naming the company as a defendant, could be a sign that the company is in financial trouble.

Additionally, once a collection case is filed, general counsel may be required to litigate or to find outside counsel to do so, thus eating up time, filing fees, attorney fees and costs — which can exceed the original demand significantly.

- **The company has suffered a significant event that will not recur.**

If the company has suffered a setback, such as the repossession of vital equipment or the death of an essential officer, it may suffer not only from the event but from the fallout. For example, a printing company cannot continue if its printing machines are repossessed; a consultancy may not survive the passing or retirement of its leading member.

- **The company's bank or secured lender has threatened to shut down business operations.**

A bank or secured lender can effectively terminate a business by calling a defaulted loan immediately due, entering a confession of

judgment on a note or mortgage or seeking to install a receiver in the business. Any of these actions can cause the company to lose money, property or both.

• **A union has threatened some type of action against the company.**

General counsel may not be aware that a company may have failed to make timely salary, benefit or pension payments to its union employees, or may have had another type of falling out with a union. As a result, the union may threaten work stoppages, wildcat strikes or picketing. Any of these actions may be the triggering event for more serious economic problems.

• **A major supplier has threatened to terminate services to the company.**

Major suppliers often have long-standing or personal business relationships with a company. Generally, a major supplier will know that an interruption in supply will be devastating to an operating business.

When the company's major supplier threatens to terminate services to the company, it is often an action bred from frustration and increased or extended debt. Sometimes the business relationship is so strained at this point that it is irreparable.

Unless another supplier stands ready to immediately step in and the company can meet the new supplier's payment demands, the major supplier's withdrawal of services can itself end the company's business.

• **The company cannot perform its contracts on time or cannot perform at all.**

Without the ability to perform contracts on time or an inability to perform them at all, a company cannot obtain the income needed to continue operations. Additionally, if this causes the company to delay in delivery or production, those delays may trigger a ripple effect on the business, its suppliers and its customers.

For example, if the distressed company is a supplier of concrete, its inability to supply concrete on a project can cause the project to be delayed. The owner may then pursue the concrete supplier not only for damages caused by finding a different supplier, but for delays on the entire project. The concrete supplier could become immersed in costly and

discovery-intensive litigation as a result of the inability to complete its contract.

• **The liabilities of the company are far greater than its assets.**

In the bankruptcy code, an "insolvent" company is one whose debts are greater than the sum of its property, assessed at a fair valuation. While a company can continue some operations when its liabilities outweigh its assets, it cannot operate for long, because no lender will lend to a company with insufficient collateral. Liquid cash is the lifeblood of a company, and most lenders will not lend cash without a balance sheet showing a solvent company.

• **The company's business model is no longer viable.**

Does the company use outdated technology or services? Are the overhead costs of the company too large as compared to its profits? Are the officers resistant to change? A company that cannot change as necessary cannot survive.

Once general counsel has identified one, several or perhaps all of these factors, what can the general counsel do to assist the company? Often, the answer is to bring in some outside professional help. Attorneys acting as general counsel often have experience in employment law, general litigation, transactional issues and other areas. But general counsel may not have experience in advising a cash-strapped company in how to reassess its business plan, its financial needs and its next steps.

There are many professionals who are independent of the pressures inherent in managing a company (including internal, emotional or family pressures) and are available to analyze and advise a company in a difficult financial position. Such professionals include:

• **Turnaround specialists.** These are professional business advisers who are able to examine a distressed company with a fresh, independent perspective to determine the sources of distress and identify ameliorative measures. Turnaround specialists can come in, examine the company, review the financial information, assess the management's business model and make recommendations regarding the restructuring of the company.

Turnaround specialists may also be available to help in the day-to-day business operations

of a distressed company, installing personnel on-site for an extended period of time in order to implement recommendations, providing accounting services and ensuring that the company follows through on its restructuring plan.

• **Attorneys specializing in advising distressed companies.** These attorneys can help to determine if a bankruptcy or forbearance agreement with a lender will enable the company to stabilize and return to its economic strengths.

Often, these attorneys bring their experience to enhance an assessment of the company's financial information. An attorney can provide not only a legal analysis of the company's situation and potential next steps (such as reorganization, bankruptcy, liquidation or workout), but also a practical solution as to what steps the company should follow in any of those situations.

• **Accountants specializing in assisting distressed companies.** These accountants can review the company's books and records to determine what may be causing the company's financial distress and advise how the financial records of the entity can be rehabilitated.

General counsel stand in an unusual position in a company. Because they are often not part of the company's management, they must glean information and ask questions to do what is best for the company. The first step on this path to recovery is to look at the early warning signs as they appear. To do this, general counsel must keep their antennae up to identify these situations.

Using the above signals may assist in the early detection of a smoldering financial problem. Once financial problems are identified, general counsel should be aware that retaining an outside professional, such as a turnaround professional, attorney or accountant, may be the first and best step to getting the company back to a healthy position. •