

# Architectural Design and Engineering Firms: Downturn lessons learned and pitfalls to avoid in the next cycle

by James Bastian, Partner, Shulman Hodges

**P**erhaps no industry or segment of the local economy has been hit harder by the Great Recession and its fallout than real estate development, and in particular, architectural design and engineering firms.

As we prepare for recovery and the real estate market begins its long climb back, players in the architectural, design and engineering arena have an opportunity to learn from many of the mistakes made during the last cycle which we saw repeated over and over again. In what is sure to be a more volatile marketplace, more than ever, firms in this space need to be more proactive and less reactive when it comes to a variety of legal issues. Below, I will discuss some of the more common errors we observed during the last downturn and some steps that can be taken going forward to allow players in this sector to be better prepared.

## Lease Issues: Less is More

In the last cycle, it appeared many firms felt the need to take down expensive space with elaborate tenant improvements, sparing no expense when it came to furniture, fixtures and equipment. Through the last cycle, we learned that these items held very little value in the context of these businesses and imposed significant monthly cash burdens and long-term liabilities associated with leases and capitalized debt structures.

One area of difficulty in the last cycle was negotiating through personal guaranties of real property leases. As landlords are trying to be as competitive as possible in filling vacancies today, it may be possible to negotiate a lease that does not include a personal guaranty.

With respect to equipment, based on the high number of defaults by architectural and engineering firms, equipment may be available on the secondary market for pennies on the dollar.

## Protecting Against Collection Risk

Architectural design and engineering firms have very powerful legal tools available to them to collect outstanding accounts receivable, including recording mechanic's liens or issuance of stop notices. In the last cycle, firms would not take advantage of these legal benefits instead erring to be courteous to their clients and not wanting to rock the boat with respect to on-going development projects. Many firms, however, learned a painful and valuable lesson when those same clients defaulted on their obligations and ultimately could not pay. In this new cycle, firms should be doing everything within their power to timely enforce their legal rights, including, if

necessary, recording mechanic's liens, filing stop notices and lawsuits when necessary.

## Bankruptcy Preference Liability Exposure

When a company files for bankruptcy protection, the trustee has the legal right to sue to avoid and recover certain payments made to creditors within 90 days of the bankruptcy filing. In the last cycle, these types of lawsuits became commonplace, hitting architectural design and engineering firms particularly hard.

Firms need to make sure that when they are in a position where their client has fallen behind on payment that they remain particularly steady when it comes to collection and payment. Keeping payments within ordinary invoice terms provides the best defense to a subsequent bankruptcy preference lawsuit. Further, having clear records setting forth what services were rendered during what period of time provides additional ammunition to defeat a potential preference claim. Documenting any agreement for repayment is particularly important rather than leaving arrangements to email chains and telephone communications. All of these things will help protect you in the event that there is a subsequent bankruptcy filing by your client and then a preference lawsuit down the road.

## Partner Buyouts Present Pitfalls

With many firms, it is not uncommon to see partner or shareholder buyout agreements entered into with respect to either retiring partners or those who wish to move on or leave the business. How these arrangements are documented and structured becomes a critical factor in the event the firm later faces insolvency. An issue that firms need to pay particular attention to is that when the buyout is structured over time through a promissory note, the parties have effectively transferred a partner or shareholder's equity interest into a debt owed by the firm. In a bankruptcy proceeding, however, it is possible that such a debt structure could be re-characterized as equity which can prove potentially beneficial or harmful to both the firm and the bought-out shareholder or partner. Whenever buyout arrangements are documented, both the firm and the partner or shareholder should evaluate the transaction in the context of what could potentially happen down the road in the event the firm becomes insolvent or bankrupt. While the normal focal point of the negotiations between shareholder and firm relates to getting the highest possible value for the ownership interest, there should be some emphasis placed on the "what if" scenario of insolvency or bankruptcy.

## Payroll Taxes

In the last cycle, many firms struggled with making payroll and often the attendant payroll tax obligation as being separate. Owners and management must understand that payroll tax obligations are largely trust fund obligations which must be satisfied at the time that the payroll is actually funded. If the trust fund portion of payroll taxes is not paid, personal liability will be imposed by the taxing authorities on management and owners. The simple rule is that if there is not enough money in the account to fund the full payroll and the payroll tax obligations that come with it, business operations should be terminated immediately and no further liability incurred. All too often, firms fall into the trap of paying the payroll to employees first and then paying the payroll tax obligation down the road when cash improves. Unlike personal guaranty exposure, personal liability imposed for payroll trust funds is likely not dischargeable in any personal bankruptcy proceeding. Therefore, it is imperative that firms view payroll tax obligations as being of paramount importance.

By no means is this an exhaustive list of all of the issues that face architectural design and engineering firms in a down market, however, the above highlights several prevalent themes that we saw during the last downturn. Learning from the mistakes many firms made will better prepare all players in this space as we head to recovery.

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## Shulman Hodges & Bastian LLP

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