Buying Distressed Assets Outside of Bankruptcy - Finding Gold in the Wild West

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An established market is a wonderful thing from so many perspectives, but not so much if you are looking for bargains.

Bankruptcy is Relatively Efficient and Can be Expensive

In days gone by, bankruptcy was a wonderfully inefficient market place. This is not to suggest that bargains can't still be had, but it just isn't what it used to be. The universe of buyers understands bankruptcy; the number of investment bankers, lawyers, and other professionals who can navigate in this environment is tremendous. Moreover, a bankruptcy case comes with heavy costs (largely in the form of professional fees) and delays (largely because of the need for creditor and court involvement).

Bankruptcy Has its Place

We're not saying that bankruptcy sales are never the way to go. Indeed, bankruptcy may offer a buyer a number of advantages not available elsewhere. The ability to purchase
property free and clear, for example, is strongest through a bankruptcy acquisition. For larger deals and/or deals where successor liability is a particular concern, the transaction costs of a bankruptcy will be far outweighed by the benefits of the process. There are certainly other reasons that may counsel toward buying in bankruptcy. The desire to cherry pick leases, for example.

But the vast majority of deals to be done don't involve real estate that may be contaminated, tort liability that poses a particular successor liability concern, or union obligations that special sections of the Bankruptcy Code can deal with in ways that no other law can.

Bankruptcy is Too Much Medicine for Most Situations

Most deals - and forgive us the sin of simplicity - involve more meat and potato situations:

- the fund that wants to buy some trade names, a customer list, and the IP necessary for an add-on acquisition; or
- the fund that already owns the number three specialty retailer in an area and that wants to pick up the number five player in the same area in order to achieve economies of scale.

A bankruptcy is often not likely to give a buyer anything that other cheaper, faster, and less invasive procedures will.
How to Proceed - Who Gets to Decide?

The buyer often decides in distressed deals.

The value of all of the seller's assets (not just the secured lender's collateral) is frequently less than the amount of the seller's secured debt. In this situation, the secured lender will play a prominent role in the sale process. And, since the secured lender wants to maximize its return, a buyer who gets in early enough can usually persuade the secured lender to push its borrower down the path the buyer is comfortable going.

So, step one is letting the secured lender know how you would like the deal to be structured. While secured lenders are not required to appease buyers on structure, most will in order to get a deal done. However, when there is heavy competition for a deal, a secured lender may be less apt to work with a buyer, knowing there are many others out there who want to buy.

The Options

The five basic choices (legal mechanisms) for a buyer of a distressed business, are to buy through:
- an ordinary stock/asset deal (which is not dealt with in this article),
- an assignment for the benefit of creditors,
- an Article 9 sale,
- a receivership, or
- a bankruptcy (and, to be clear, a bankruptcy purchase may be through a 363 sale or may be through a plan. Moreover, it is also possible to effect an acquisition of a debtor's assets by purchasing a sufficient amount of claims against that debtor).

Regardless of the legal mechanism, some things will be the same as a typical, non-distressed acquisition: the basic transaction documents (asset purchase agreement (sometimes), bill of sale, etc.) and issues (price, definition of what is being acquired, etc.). At the same time, the distressed nature of the seller creates new issues and resolves or minimizes some issues found in a non-distressed deal. Seller representations that survive closing, for example, are few and far between. There are, however, more differences than similarities among these mechanisms and deciding which one is optimal in any given situation requires consideration of:
- The assets you seek to purchase and the risk profile those assets bear.
- The location of the assets (and the venue options of any legal proceeding). This is key. How much protection a buyer can get will depend on both the specific process and where the process takes place.
- Your appetite for competition. In a bankruptcy case, whatever you offer will be subject to higher bids in some sort of competitive process. This can sometimes be avoided outside of bankruptcy.
- Whether you need one or more of the results that only the Bankruptcy Code can achieve.
- Whether there is a creditor who has a lien on the assets you want to buy.
- Whether the buyer needs the business to continually operate without any interruption.
- Whether the business can survive the strains that come with a bankruptcy.

Brief Overview of Buying from an Assignee

An assignment for the benefit of creditors (ABC) is an out-of-court alternative to bankruptcy liquidation. An ABC typically requires the cooperation of the debtor and its secured lender.
The basic process and procedure of an ABC and a liquidating Chapter 11 or Chapter 7 bankruptcy are somewhat similar: immediately following execution of the ABC document, the assignee takes possession of and inventories the assets. The assignee will then decide whether the business operations should cease or continue so as to preserve going concern value. The assignee will market and then sell the assets.

An ABC is better than some options when the business is a going concern or requires a few months of wind down operations. An assignee is much more apt to operate a business than a Chapter 7 trustee. The ABC process is usually less expensive than selling through a bankruptcy.

However, the assignee sale can be treacherous if a buyer has not done its diligence. Assignee sales do not wipe out liens and, typically, assignees do not make any representations about existing liens. This risk can be reduced if the assignee holds a liquidation sale in conjunction with the secured lender's Article 9 sale.
Brief Overview of Buying at an Article 9 Sale

Article 9 of the Uniform Commercial Code governs the relationship between a debtor and its secured creditors with respect to goods. Generally, a secured creditor may seek to enforce its rights in its collateral upon a borrower's default. A secured creditor's remedies include the right to sell the collateral to a third party. The secured creditor may pursue this remedy notwithstanding the borrower's objection. In other instances, particularly where a borrower wants to reduce liability on a personal guaranty to the secured creditor, the borrower may cooperate. This is sometimes called a ""friendly foreclosure.""

Article 9 of the Uniform Commercial Code allows a secured party, after a borrower default, to sell all of its collateral in any commercially reasonable manner. An Article 9 sale cuts off junior liens and allows the senior lender to convey good title to a purchaser. To minimize potential successor liability claims, the purchaser should not permit the seller's principal(s) to retain any equity position in the target.

Beyond fairly minor noticing requirements to the borrower and any other secured creditors and others with interests in the collateral, the lender's main guidepost is to proceed in a ""commercially reasonable"" manner with
respect to all aspects of the sale. The exact manner in which a secured creditor proceeds will be governed by the nature and value of the collateral. A public or private sale may be used. Private sales have the advantage for a purchaser that there will be no public auction and thus, fewer opportunities for competitive bidding. Conversely, a secured lender may prefer a public sale in order to have a better argument that it conducted a commercially reasonable sale.

Article 9 sales also can be dangerous for an uneducated buyer. One has to be careful of potential possession issues as well as senior liens that will not be wiped out by the sale, or even junior liens that can become senior after time, such as an IRS lien that becomes a priming lien 45 days after filing.

Brief Overview of Buying from a Receiver

A receiver is most often appointed at the request of a secured creditor that fears that its collateral will be dissipated or otherwise harmed. In a typical case, a receiver is empowered to operate the business, to take possession of property, to bring or defend actions, to collect rent or debts owed, and to take all other actions in furtherance of the court's directives. A receiver is not always, but may be, authorized to sell the assets of the company.
If a receiver is authorized to sell the assets, it will do so under the supervision of the court. In most such instances, the receiver will move the court to approve a sale procedure. Then, the receiver will advertise the sale for several weeks in order to maximize recovery. Sales may or may not be subject to existing liens. Subsequent to the sale, the receiver may also move to the court to approve the sale. The receiver sale process is can be much less expensive or time consuming than a bankruptcy.

*Conclusion*

Re-wind 30 years to when the Bankruptcy Code was enacted and when most of the 10,000-20,000 professionals who currently consider themselves to be bankruptcy professionals were still in high school (or diapers) and what you had was a Wild West where great deals were had and fortunes were made. Well, that market has matured to the point of being pretty darn predictable, safe, and, well, efficient. You want a deal? Go to the new West and look to do your next deal outside of bankruptcy. It's not for the faint of heart, but with greater risk comes greater reward.