DISPOSITION OF ASSETS OF DISTRESSED COMPANIES

By

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Hedge fund managers, who have acquired assets of financially-distressed companies in bankruptcy sales and through other methods, may now find themselves in a position where, despite best efforts, the acquired company continues to perform poorly. In fact, the company may be performing so poorly that it is time to cut losses and dispose of its assets. These circumstances may place many hedge fund managers in unchartered territory. This article examines options available to the hedge fund to turnaround the investment or, if a turnaround is not possible, to monetize the investment through various alternatives for disposing of the assets.

Turnaround Options

As funds to support company growth became more abundant in the 90's, many former CEO's, accountants and business consultant became "turnaround managers" to assist investors of troubled companies. Turnaround managers are hired by the Board of Directors, or at the request of secured creditors, of a company that is failing. The turnaround manager often replaces the CEO but at times is hired to supplement the efforts of existing management.

Turnarounds are generally of two types – operational turnarounds and strategic turnarounds.

Strategic turnarounds ordinarily occur where the market for the product has disappeared or the business model simply doesn't work. They involve finding new products or markets, or new way of selling, and ordinarily require a significant cash infusion. Strategic turnarounds are the most difficult type of turnaround and require patience by the owner and a turnaround manager who is top-line driven (while keeping costs an expenses sensible in relation to revenue drivers).

Operational turnarounds are far less expensive and based on a different approach to management. The four most common signs that a company may benefit from an operational turnaround include:

1. The company has poor management reporting – managers cannot tell you how the company is doing, where and why it is succeeding, and where and why it is failing

2. Management is fractured. Managers of the company (or the Board and management) are undermining each other, have different agendas, and do not have a shared vision and plan for success.

3. Management does not want to make changes, because a major sale or sales will shortly change the financial picture of the company (and the company is running low on cash waiting for the miracle sale).

4. The founder of the company is still in control or has too much influence and the company is operationally impaired. The founder(s) prevents appropriate delegation of responsibility and accountability and/or pulls the company from one direction to the next with his/her latest idea thereby undermining operational management.

Before looking at disposition of assets, the owners or secured creditors of a company should first determine whether an operational (or, in rare cases, strategic) turnaround could help, and then select the right turnaround firm.

Many turnaround firms come out of the accounting and consulting worlds, and approach turnarounds without the benefit of hands-on, in the trenches, experience. In determining whether a turnaround firm or manager can be effective, the owners should consider the following:

- How does the firm or person communicate with key constituencies? A turnaround can only work through an approach of effective and frequent communications with employees, vendor, customers and owners. Consultants and accountants will focus on theory and advice; effective turnaround managers focus on people and results.

- What is the track record of the turnaround firm?

- How will the firm staff the engagement?

- Does the firm focus only on cutting costs? How does the turnaround firm/person intend to build the top-line? What will be the approach to sales/marketing?

<u>Disposition of Asset Options</u>

In those cases where the company cannot be saved, three methods are commonly used to monetize the assets of troubled companies: (1) a “363 Sale” or sale of substantially all the assets of a company (not infrequently as a going concern) in a Chapter 11 bankruptcy; (2) sale of assets following an Assignment for the Benefit of Creditors; and (3) a “Code Sale” by a secured party under the UCC. Each of these methods has its own advantages and disadvantages.

1. <u>A "363 Sale"</u>

Asset sales under Section 363 of the Bankruptcy Code have recently become the preferred method of monetizing the assets of a debtor company. The 363 process ordinarily involves a Chapter 11 debtor/seller and a prospective buyer presenting a fully negotiated asset purchase agreement ("APA") to the bankruptcy court for approval. This purchase agreement then becomes the template against which other potential buyers bid in an auction, pursuant to a set of court approved procedures. Once a winning bidder is selected, the transaction closes with the sale being free and clear of prior liens and most claims, including claims by creditors that have not been paid at the time of the sale.

The process often has the advantages of speed and the ability to maximize value of assets through sale of the debtor company as a going concern. It is not unusual for a 363 sale to be completed within two to three months after a bankruptcy filing. The assets are cleansed in that they are sold, with certain limited exceptions, free and clear of liens, claims, and liabilities. Also, a 363 sale can often yield the highest price for the assets because of the buyer's ability to select liabilities it will assume and to purchase a going concern.

From the seller's standpoint, the Section 363 process is advantageous because it can limit exposure of directors and officers of the seller for breaches of representations and warranties. In addition, a secured creditor can "credit bid" or take an ownership interest in the company by bidding a reduction in the debt the company owes it although, from a practical standpoint, there will typically need to be a cash outlay by the secured creditor to purchase the company in order to address the unsecured creditor constituency and cure certain claims.

The disadvantages of a 363 Sale are that it can be time-consuming and expensive because the sale and its procedures must be approved by the bankruptcy court, and the sale is subject to objection by interested parties. Because the sale is an auction, the secured party may lose control of the sales process, and the process may generate more scrutiny from interested parties and highlight troublesome issues.

In addition, management during a 363 Sale is extremely difficult and interim managers with experience in the process often are hired because of the complexities of the process. Common mistakes made in 363 Sales are as follows:

- Failing to verify ownership of assets being sold. It is not unusual for creditors to find creative ways to claim liens on assets and thus undermine consummation of a transaction because ownership is unclear.

- Neglecting valuation issues and failing to close (or getting highly reduced proceeds in) a sale because of purchase price adjustment issues arising based on questions as to collectability of AR or valuation of inventory.

- Losing employees or depleting assets of the company because employee issues were not properly addressed.

- Failing to recognize the conflict of managers with respect to who buys the company and when and how it is sold, and management's inability to deal with losing control of the company, following a long battle to keep it alive.

2. <u>An Assignment for the Benefit of Creditors</u>

An Assignment for the Benefit of Creditors is a legal mechanism to liquidate the assets of a business under state law by assigning all the business assets to an Assignee under an Assignment Agreement or a Trustee under a Trust Agreement. A company may be sold as a going concern in an Assignment for the Benefit of Creditors. The Assignee (Trustee) serves as a fiduciary of the company for purposes of liquidating assets by selling them, and distributes the proceeds of the liquidation to creditors in accordance with a state statutory scheme.

These schemes differ. For example, in some states, shareholder approval is required prior to the assignment. In other states, the process is undertaken pursuant to court supervision and specific notice requirements may exist. Under certain state laws, the sale must be conducted in a manner, and based on terms and conditions, set or approved by a court, or the assignee must get court approval before the assets are sold.

The advantages of an Assignment for the Benefit of the Creditors are that it can be accomplished quickly at far less expense than a bankruptcy proceeding. The company has greater control because it chooses the assignee and an auction does not occur. The notice requirements are somewhat less stringent than a 363 Sale, although the assignee must give reasonable notice to fulfill fiduciary duties to creditors.

The disadvantages of an Assignment for the Benefit of Creditors is that, unlike a 363 Sale where the assets are, in general, delivered free and clear of liens, the buyer in an assignment for the benefit of creditors obtains the assets subject to liens (unless the lienholder agrees to release the lien). In addition, creditors still have the option to undo the sale and file an involuntary bankruptcy against the troubled company. The creditors also may freeze or seize assets pre-sale disrupting the ability of the Assignee to consummate the sale.

3. <u>A "Code Sale"</u>

A secured creditor of a troubled company may sell assets securing its claims under the Revised Uniform Commercial Code ("UCC"). The UCC allows a secured party, after a default of a debtor, to "sell, lease, license or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." The limitation on the sale is that it must be commercially reasonable in manner, method, time, place and terms.

The advantages of a Code Sale are that is quick and inexpensive. Selected assets may be sold as opposed to substantially all the assets as in a 363 Sale or Assignment for the Benefit of Creditors. And, the secured creditor, as in a 363 Sale, may credit bid, if the bids are insufficient to satisfy the debt, and take ownership of the assets. The assets are sold without intervention by a court or an assignee/trustee.

The disadvantages of a Code Sale are that the account debtor or other creditors may challenge the reasonableness of the sale. The secured party has the burden of identifying and providing all appropriate notices. And, the Code Sale shares many of the disadvantages of an Assignment for the Benefit of Creditors in that the title to the assets is not cleansed, the sale may be undone,and the assets may be seized or frozen before or after the sale.

Conclusion

Determining how best to deal with a troubled company is a complex and difficult assessment. The decision of whether or not to attempt a turnaround of a distressed company, or how best to dispose of its assets, can have enormous implications for the eventual recovery of an investment by an owner or secured creditor. Guidance of professionals with experience in these areas can make an enormous difference. With proper assistance, an approach can be chosen that will yield optimal results for the company and its constituencies in a quick and painless fashion.

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