ACQUISITIONS AND DISPOSITIONS OF ASSETS OF TROUBLED COMPANIES

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I. INTRODUCTION

Virtually every troubled company is faced with the possibility that it will be forced to sell at least a portion, if not substantially all, of its assets. When those assets are the collateral securing a bank loan, the bank has a strong incentive to be actively involved in, or even to dictate the sale process. Three methods are commonly used to sell assets of troubled companies in Illinois: (1) a "363 Sale" of assets under Section 363 of the United States Bankruptcy Code; (2) a sale of assets following an "Assignment for the Benefit of Creditors"; and (3) a "Code Sale" by a secured party under Article 9 of the Revised Uniform Commercial Code. Each of these methods has its own set of advantages and disadvantages; therefore, every troubled company situation should be evaluated on a case-by-case basis. These materials provide a brief overview of these three methods.

II. SALE OF ASSETS UNDER SECTION 363 OF THE BANKRUPTCY CODE

Bankruptcy is no longer an option of last resort for troubled companies. Under the right circumstances, it is a versatile (and sometimes advantageous) vehicle to sell assets of a troubled company because Section 363 of the United States Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code") provides a buyer with a great degree of protection and comfort that, pursuant to a federal Bankruptcy Court Order, the assets are being bought "free and clear" of any liabilities of the troubled company. The assets are often described as being "cleansed" by the bankruptcy. This cleansing can have a substantial impact on the value of the assets being sold, and sometimes makes the difference between a marketable asset and an unmarketable asset. But it also presents challenges. Because bankruptcy sales are typically conducted as public auctions, notice of the sale must be given to all parties in interest, and 363 Sales are expensive and somewhat complicated.

A. <u>Advantages of a 363 Sale</u>.

1. Assets are "cleansed"—sold "free and clear" of essentially all liens, claims, encumbrances and liabilities of the troubled company—and the Bankruptcy Court will usually make a finding of the buyer's "good faith" under Section 363(m) of the Bankruptcy Code.

    a. Potential Exceptions: limited successor liability claims including, among others, (i) certain product liability claims when a manufacturing business continues, and (ii) ongoing environmental claims.

2. The automatic stay under Section 362 of the Bankruptcy Code provides breathing room to the troubled company to market and sell its assets by "staying" the entry of unfavorable judgments or liens that could otherwise derail a sale of assets.

3. The Bankruptcy Code provides a mechanism to determine the validity, priority and extent of liens against the assets, with such liens to attach to the proceeds.

4. The Bankruptcy Code allows a secured creditor to "credit bid" at the sale under Section 363(k) of the Bankruptcy Code.

5. A 363 Sale is typically conducted as a public auction, although private sales can be approved under limited circumstances. A public auction may generate more interest and competitive bidding from prospective buyers, but also has disadvantages in certain situations.

6. The initial bidder at a 363 Sale, often referred to as the "stalking horse bidder," may ask for certain benefits and protections including:

a. Overbid Protection – The first bid after the initial bid by the stalking horse bidder must exceed the initial bid by a certain amount (typically 3% to 10%, depending on the amount of the sale). For example, if the initial bid by the stalking horse bidder is $2,000,000, no competing bid will be considered unless it exceeds the initial bid by at least $100,000.

b. Breakup Fee – A fee paid to a bidder, most frequently the stalking horse bidder, in the event that its initial bid is not the winning bid at the auction, or the sale to the stalking horse bidder does not close for certain reasons agreed between the seller and the stalking horse bidder. Typically, the amount of the breakup fee is less than the amount of the overbid protection.

B. <u>Disadvantages of a 363 Sale</u>.

1. A 363 Sale can be time-consuming and expensive because the sale and procedure for the sale must be approved by the Bankruptcy Court, notice must be provided to all parties in interest, and the sale is subject to objections by interested parties.

2. The bank has only limited control over the sale process because the sale and procedure for the sale must be approved by the Bankruptcy Court, notice must be provided to all parties in interest, and the sale is subject to objections by interested parties.

3. The sale is typically conducted as a public auction, which may generate more scrutiny from interested parties and may highlight troublesome issues, but also may provide advantages in certain situations.

4. There is the potential for lien stripping under the Bankruptcy Code—bifurcation of a secured claim (into a partially secured and partially unsecured claim)—based on the "value" of the collateral.

5. There is the potential for the debtor-in-possession or trustee, as the case may be, to surcharge the bank's collateral for the reasonable, necessary costs and expenses of preserving, or disposing of, such collateral to the extent of any benefit to the bank under Section 506(c) of the Bankruptcy Code.

III. SALE OF ASSETS PURSUANT TO AN ASSIGNMENT FOR THE BENEFIT OF CREDITORS

An Assignment for the Benefit of Creditors is a legal mechanism used to liquidate substantially all of the assets of a business under state law by effectuating an assignment of all of the business' assets to an "assignee" or trustee under a trust agreement. The assignee serves as a trustee/fiduciary for the purpose of liquidating the assets of the business and distributing the proceeds of liquidation to creditors, in accordance with the priority scheme set forth under state law. Assignments for the Benefit of Creditors are common in several states, including Illinois, but are uncommon in many others. Some states require shareholder approval in order for a company to enter into an Assignment for the Benefit of Creditors (Illinois and Delaware), while others require only board of director approval.

In Illinois, Assignments for the Benefit of Creditors are authorized under Illinois common law, and, therefore, do not require any court action or supervision. In other states, such as Michigan and New York, Assignments for the Benefit of Creditors are statutory and require court supervision. A Copy of the Michigan Assignment for the Benefit of Creditors statute is attached for reference.

A. Advantages of a Sale of Assets through an Assignment for the Benefit of Creditors.

1. An Assignment for the Benefit of Creditors can be accomplished very quickly and can be significantly less expensive than a bankruptcy proceeding.

2. The troubled company (with guidance from the bank) chooses the assignee, and therefore has greater control over a sale of assets in an Assignment for the Benefit of Creditors than in a bankruptcy proceeding.

3. The assignee is not required to comply with the stringent notice and timing requirements of a 363 Sale, but notice still must be reasonable in order to satisfy the assignee's fiduciary duties to the creditors. However, the assignee must adhere to any notice requirements required under the applicable state law. For example, Michigan law specifies the notice that must be given by the assignee.

4. The assets of the troubled company are transferred out of the control of the current management and into the hands of a neutral third-party assignee. Under Michigan and New York law, the assignee must post a bond.

5. In Illinois, there is no state or federal court proceeding; the assets are sold without court intervention. However, in Michigan, the assignee must file an application with the court before it can sell assets. Under New York law, the sale must be in a manner, and on the terms and conditions, set or otherwise approved by the court.

6. Typically, the troubled company (with guidance from the bank) chooses an assignee who has experience marketing assets of the type being sold and has contacts in the subject industry.

7. A good assignee can and will sell the assets of a business as a going concern, and operate the business pending the sale to a predetermined buyer, with the cooperation of the bank.

8. An Assignment for the Benefit of Creditors greatly deters litigation by creditors of the troubled company (particularly if a well-known and reputable assignee is chosen), and the assignment may "trump" a subsequent judgment lien.

B. Disadvantages of a Sale of Assets through an Assignment for the Benefit of Creditors.

1. A sale by an assignee does not provide a buyer with a "cleansed" title to the assets "free and clear" of all liens, claims, encumbrances and liabilities. In fact, the assignee — and therefore the buyer — obtains title to the assets, subject to liens, unless the lienholder releases the lien. Therefore, the purchase is riskier to potential buyers.

2. Recalcitrant creditors may attempt to "undo" the Assignment for the Benefit of Creditors and the assignee's sale of assets by filing an involuntary bankruptcy against the troubled company.

3. Unlike a bankruptcy, there is no "automatic stay" of litigation against the troubled company, and creditors may seek to seize, place a lien on or otherwise freeze, the assets.

IV. A "CODE SALE" BY A SECURED PARTY UNDER ARTICLE 9 OF THE REVISED UNIFORM COMMERCIAL CODE

A secured creditor of a troubled company may sell the assets securing its claims (*i.e.*, its collateral) under Section 9-610(a) of the Revised Uniform Commercial Code (the "UCC"). The UCC allows a secured party, after 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 key issue in any Code Sale is whether the sale is "commercially reasonable." Every aspect of the sale must be commercially reasonable, including the method, manner, time, place, and all other terms.

A. Advantages of a Code Sale.

1. A Code Sale may be accomplished very quickly (usually within 45 days) and is significantly less expensive than a bankruptcy proceeding or an Assignment for the Benefit of Creditors.

2. Select assets may be sold at a Code Sale. The bank need not sell "substantially all of the assets" of the troubled company.

3. The bank may dispose of the collateral by a public or private sale, but always must do so in a commercially reasonable manner.

4. The bank may "credit bid" for the collateral being sold at the Code Sale, and often does so if the bids are insufficient to satisfy the bank debt.

5. The bank controls the terms and conditions of the sale, but every aspect must be "commercially reasonable."

6. There is no state or federal court proceeding; the assets are sold without court intervention, and without the intervention of a bankruptcy trustee or third-party assignee.

B. Disadvantages of a Code Sale.

1. The burden is on the bank (as opposed to an assignee in an Assignment for the Benefit of Creditors or a trustee in a bankruptcy proceeding) to conduct a commercially reasonable sale. The account debtor, a creditor, or a party in interest may later challenge the reasonableness of the sale.

2. The Bank bears the burden of locating all parties who may have an interest in the assets and provide them with notice of the sale, and the UCC notice requirements are strict and must be followed carefully. However, Section 9-613 of the UCC provides a "safe harbor" form containing the information that must be provided to parties in interest in order to be deemed commercially reasonable.

3. Access to the collateral, and books and records relating to such collateral, may not be available to potential buyers prior to the Code Sale.

4. Additionally, a Code Sale shares the disadvantages of an Assignment for the Benefit of Creditors:

a. A Code Sale does not provide a buyer with a "cleansed" title to the assets "free and clear" of all liabilities. Therefore, the purchase is riskier to potential buyers.

b. Recalcitrant creditors may attempt to "undo" the Code Sale by filing an involuntary bankruptcy against the troubled company.

c. Unlike a bankruptcy there is no "automatic stay" of litigation against the troubled company, and creditors may seek to seize, place a lien on, or otherwise freeze, the collateral being sold.

V. CONCLUSION

Each of the three methods of disposing of assets of a troubled company described above are highly effective and powerful tools for a bank. Choosing the best method could greatly enhance a bank's recovery by maximizing the value of the assets being sold, but each method also has its own pitfalls and disadvantages. A bank can minimize or avoid altogether these pitfalls with the guidance of professionals who have a strong understanding of the issues relating to the sale of assets of troubled companies.