



By Brian L. Davidoff

HOW TO LIQUIDATE THE ASSETS OF A TROUBLED COMPANY *A Practical Primer*

Background

In today's environment, lenders and venture investors (many of whom often sit on the company's board of directors) often find themselves in a position where their company is losing money and efforts to sell

the business at a multiple of earnings have failed. The lender/investor is then faced with the prospect of having to oversee the wind down of the operations of the entity, liquidation of its assets and distribution of the proceeds to the creditors and, if the company is lucky enough to have excess assets, the balance to the shareholders. This article will briefly explore the alternatives available to the lender/investor in the winding down of a company.

Be aware that when a business enters the "zone of insolvency" the fiduciary duty placed on the board of directors shifts from the guardianship of the shareholders to the guardianship of the creditors. Only once the creditors have been satisfied in full from the assets of the company does the duty of the board then again align itself with interests of the shareholders.

Alternatives

There are several alternatives available for winding down and/or selling the assets of a distressed company. The alternative chosen will depend upon the particular circumstances of the situation, which might include whether the intention is to auction the assets of the company; whether the intention is to sell the remaining

assets of the company; whether management is available to undertake the efforts necessary to wind down the affairs of the company; the cost of alternative methods; and the nature of the business. More often than not, the wind down of a technology company takes a different path from the wind down of a traditional "brick and mortar" company. This is because technology companies employ human capital (which is highly mobile) as their stock in trade, whereas the traditional "brick and mortar" company has inventory and other fixed

assets that may be of substantial value. In the case of a technology company, usually the retention of the human capital is critical if the lender/investor is to realize any return on its investment in the company.

Out of Court Wind Down

Basic Rule: This is the wind down of the operations of the company by existing management without any court supervision. This method of wind down requires that either some members of existing management remain available to conduct the wind down of the company, or that a specialist is employed for this purpose. Their function will be to dispose of the assets of the company whether by private sale, public auction or other means, and to pay the proceeds to the creditors and, if any, excess to shareholders.

While this approach often is the least expensive alternative, it also is the most uncertain for a variety of reasons. First, when creditors learn of the wind down of the operations, some creditors may bring legal proceedings to attach the assets of the company. Any

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such action will often derail the orderly disposition of the company's assets. Second, creditors may seek to file an involuntary bankruptcy against the company. This requires three creditors who have aggregate unsecured claims of \$11,625 owed to them. Third, the out of court wind down of a company often does not bring finality to the end of the business. There is no formal notice that is given to creditors indicating that the business has ceased and creditors sometimes continue suing the company for months, if not years, after the cessation of operations. While it is typical that a creditor's claim is against the company alone, it does not take much for a creditor to add the name of an individual officer or director of the company to the lawsuit. There may be no merit to such a suit but someone still needs to be engaged to monitor this litigation.

Chapter 7 Liquidation

Basic Rule: In a Chapter 7 bankruptcy, a trustee is appointed by the bankruptcy court. Trustees are usually lawyers or accountants whose job it is to collect all the assets of a company and liquidate them for the benefit of creditors. The bankruptcy code has a priority scheme for the payout of creditors as follows: secured creditors, administrative creditors (which include the cost of the bankruptcy, wages, taxes, deposits on goods not delivered and certain other items), unsecured creditors and finally, equity holders. There is no discharge of the corporation's liabilities in a Chapter 7 liquidation, nor is the corporation automatically dissolved in the Chapter 7. In other words, even though the assets of an entity may be liquidated through a Chapter 7 bankruptcy, those liabilities are not legally discharged. Accordingly, the principals of such a company would never use that entity as a vehicle for further operations even though it might have been through a Chapter 7 bankruptcy because the debts still remain in existence (unless they have been fully paid through the Chapter 7 liquidation).

The principal benefits of a Chapter 7 liquidation include the fact that it brings some finality to the cessation of the business. A notice is sent to creditors by the bankruptcy court indicating both that the company has filed a Chapter 7 bankruptcy and whether or not assets are available for distribution. In the event that assets are available for distribution, creditors may file claims in the bankruptcy case and receive a pro rata distribution of the assets available. The receipt of a Chapter 7 bankruptcy notice also tends to flush out creditors. In other words, not

only will creditors file their proofs of claim, but if they believe they have any claims against the officers or directors of a company, the notice often initiates those proceedings promptly. This allows the directors and officers of a company to "close the books" of the company after the Chapter 7 has been concluded. Alter ego claims are, in any event, owned by the Chapter 7 Trustee, thus precluding a direct suit by a creditor against the officers and directors on this cause of action.

Another principal benefit of a Chapter 7 is that the assets are delivered to a Chapter 7 trustee whose responsibility it is to conduct the liquidation and disposition of the assets. This is important if the company either has no remaining management or does not have the finances available to hire somebody to conduct the wind down of the business.

Chapter 7 bankruptcies also tend to require less out of pocket costs to the lender/investor. Normally the legal costs for filing a Chapter 7 bankruptcy are significantly less than those for a Chapter 11 or other kinds of wind downs. On the other hand, this benefit is often overshadowed by the principal detriment of a Chapter 7 bankruptcy: if the intention is to preserve any vestige of going concern value of the business, Chapter 7's are not the appropriate vehicle. This is because the Chapter 7 trustee is not allowed to operate a business in a Chapter 7 without specific court permission and more importantly, Chapter 7 trustees act notoriously slowly. Even though they have the ability to engage in a quick sale of the remaining assets, they rarely do. Usually the tangible assets of a business which is no longer in operation are sold at a fraction of the value otherwise attributable to assets sold as part of an operating business.

Chapter 11

Basic Rules: Unlike in a Chapter 7, in a Chapter 11 management of the company remains in place as a debtor in possession ("DIP"). No trustee is appointed unless the DIP has engaged in inappropriate conduct or other fraudulent acts, in which event a trustee might be appointed. A Chapter 11 is very flexible; it allows a company to either liquidate under the control of the DIP, sell the assets or reorganize. More often than not, management (often with professional assistance) is in a better position than a trustee to maximize the return on the asset liquidation.

The Chapter 11 process does, however, require that there be existing management available or that funding is available to hire appropriate expert personnel to manage the company through the Chapter 11. In addition, the out-of-pocket cost to the lender/investor of a Chapter 11 tends to be significantly more expensive than in a Chapter 7. This additional out-of-pocket cost, however, is often justified by the greater return that can be obtained from a sale or liquidation of the assets under the control of management in a Chapter 11.

A common device used in a Chapter 11 is the employment of a “section 363 sale.” Under this procedure, all of the assets of the company are sold pursuant to a court approved sale outside of a Chapter 11 plan. Following this process, it is often possible to conduct a “section 363 sale” soon after the filing of a Chapter 11. During the interim period between the filing of the Chapter 11 and the “section 363 sale,” to keep the company afloat, a lender/investor might invest further funds pursuant to a court order whereby the loan has a priority return.

Not only does the Chapter 11 allow management to control the disposition of the assets of the company, but often it is the preferred route of a buyer of distressed assets. A “section 363 sale” can be “free and clear of liens.” A buyer can accordingly obtain considerably more comfort that the assets acquired do not have any remaining liabilities attached to them (other than possibly environmental or latent defect liabilities). Rather, the liabilities attach to the proceeds that the buyer pays to the bankruptcy estate. Buyers of distressed assets, as a result, often dictate that the seller conduct a “section 363 sale.”

One of the principal drawbacks of a “section 363 sale” is that it is subject to overbidding. While this is theoretically in the best interest of the bankrupt debtor company, it does expose the buyer to the risk of overbidding and loss of the transaction. Various devices are employed by buyers to minimize this possibility, although in the end a third party can step in, pay more money and scoop up the assets.

Assignment for Benefit of Creditors

Basic Rule: An assignment for benefit of creditors (“ABC”) is a state law alternative to a Chapter 7. Under an ABC, all of the assets of the company are assigned to an independent third party “assignee” who then has the responsibility to liquidate those assets for the benefit of the creditors of the company. The assignee can sell the assets either in a public sale or in a private transaction.

One of the principal benefits of an ABC over a Chapter 7 is greater flexibility. Very often the assignment of the assets from the company is implemented in conjunction with the assignee’s agreement to sell the assets to a pre-selected third party. This private sale procedure is available provided that the assignee is satisfied that the private sale is commercially reasonable and at least equal to the fair value of the company’s assets. In this way, the lender/investor will often realize a greater return than that occurring from a delayed sale in a Chapter 7 liquidation. Further, an ABC is often less expensive than a Chapter 11.

The principal drawback of an ABC is that it is a creature of California statute. Accordingly, if the assets to be disposed of are located in different states, the ABC will not necessarily carry legal weight in other jurisdictions. In addition, an ABC is a device simply not as well known as a sale of assets under a section 363 sale. Accordingly, buyers often are more skeptical about the benefits of this approach and thus sometimes are not willing to adopt this as an acceptable method.

Conclusion

The above represents the principal alternatives to the wind down and disposition of the assets of a distressed company. Which one is right depends on the particular circumstances of the company. For further information contact Brian L. Davidoff. Tel: (310) 286-1700; email: bdavidoff@rutterhobbs.com

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