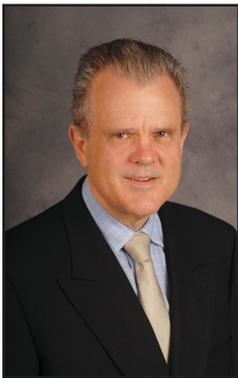


Buying And Selling The Distressed Small Business



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Is your client seizing an opportunity or courting a catastrophe?

SUPPOSE THAT the decisionmaker of a troubled small or mid-sized business has decided to sell it. What are some of the considerations and consequences that flow from that decision? Who is the decisionmaker? What is "value" in the particular transaction? How can that value best be realized? And have you, as the professional, delivered value?

The threshold issue, however, is whether the business can be sold. Not all businesses can be sold as going concerns. Some troubled companies simply cannot live long enough to get through closing a sale. Further, sales of troubled businesses often return nothing to equity and may even produce insignificant returns to creditors.

Before doing anything else, a professional for a troubled small business should counsel the decisionmaker to take a hard look at whether the business should be shuttered immediately rather than sold as a going concern. Immediate closure followed by sale may be the best result for everyone except, perhaps, the professionals.

If the sale proceeds, it can proceed either:

- Outside bankruptcy, which is usually faster, cheaper, and more private, but provides less protection for buyers, owners, and management; or

- Inside bankruptcy, which is slower, more expensive, and public but provides a number of benefits, including more protection for buyers, owners, and management, an automatic stay, and a forum for addressing related issues.

1. WHO IS THE DECISIONMAKER IN A DISTRESSED SMALL BUSINESS?

• It may seem like a simple question, but it isn't. It boils down to "Who is your client?" and there may be more than one possible answer.

Identifying The Decisionmaker

The managers or owner/managers of a troubled company may not be the appropriate decisionmakers. Some form of conflict of interest is typically, although not always, to blame. In some instances, a member of the board, an outside consultant such as a turnaround consultant, or other person may be a far better choice. A professional should evaluate and identify potential conflicts up front and advise separate counsel when necessary. This is a particular issue in dealing with public companies.

Nearly all business problems derive ultimately from financial issues, primarily cash flow or a weakening balance sheet, usually combined with a drastic or continuing management problem. In many troubled companies, management has either been recently replaced or has left and not been replaced by the time the situation deteriorates.

Managers and owners may have agendas ranging from desires to depress prices to facilitate an insider deal or maximize the likelihood of jobs with the buyer, to avoid embarrassment or exposure, to limit personal liabilities, or to facilitate a companion deal that does not benefit the company, such as a consulting contract or a lease on real estate used by the company.

Others may be in the decisionmaker role. Often creditors, particularly secured creditors, employees, family members, affiliated entities, and others have

serious economic interests in troubled smaller businesses and may try to play an active role in running the show.

Why Is This A Different Inquiry Than With Healthy Large Businesses?

With smaller and troubled companies, there is pressure to limit fees and work fast. Hypothetical conflicts that exist in the sale of a healthy company can become major conflicts very quickly in the troubled company context. As prices drop and costs increase, guarantors may suddenly see themselves having to pay on their guaranties instead of retiring on their sales proceeds. When conflicts ripen quickly, professionals may find it difficult to address the issues effectively as they arise.

Where The Attorneys Fit In

Absent care, professionals for troubled sellers may be employed de facto by a combination of the management, the guarantors, the secured creditors, and others with interests that are only occasionally consistent. Poorly conceived or drafted engagement letters lead directly to unpaid or disgorged fees, unnecessary disputes, and malpractice claims. Even absent actual conflicts, courts have imposed stricter disclosure requirements on professionals.

Professionals who were told not to waste money may be the only live targets if something goes wrong later. Particularly in a family or other closely held business, owners may not maintain rigid separation between themselves and their companies. They may also panic or become emotional.

2. WHAT IS "VALUE"?

• What are the seller's primary value expectations and can they be met? As eBay proves every day, value is in the eye of the beholder, whether the buyer or the seller. Here, the inquiry begins with what tangible or intangible assets or aspects of the seller the market may value and what the seller wants out of the transaction.

What Does The Seller Have To Sell?

Can the business be sold as a going concern? Particularly for closely held businesses, owners are reluctant to sell when business is trending down. They prefer to hold out and try to fix the problem, then sell when the price will be higher. When the downward trend continues, owners are even more reluctant to sell because the price will be even lower. Legal and nonlegal professionals are crucial to ending the spiral and facilitating the sale of whatever is left by then. Often, the key is to address either directly or obliquely one of the greatest causes of business death: the inability of owners and management to admit failure, articulating that continued operation simply is not an option, and refocusing everyone's attention on executing a sale.

In evaluating whether a going concern sale is possible, the seller's professionals should ascertain whether the seller owns all of the assets necessary to run the business, such as leases, licenses, and contracts. Business assets may be owned or in a position to be tied up by others, such as owners or affiliates. These issues must be identified early and may call for separate counsel. If so:

- Is the business best sold as a whole or in a repackaged form? Sometimes a business is more appealing to buyers if it has been reconfigured or trimmed down;
- Is the business better sold on a "go dark" basis? If attempting to capture the going concern value is an iffy proposition, what is the salvage value of the assets?
- Is there a strategic solution? Does the seller offer a chance to eliminate itself as a competitor, acquire a complementary product line or key contract or lease? Other than the first, these are harder in troubled business situations. Occasionally, a troubled service provider can sell a smooth landing.

Seller Values May Not Be Obvious

Seller values and priorities are often surprising and not measured in cash. For example, the seller may most value:

- Freedom from personal guaranties;
- A consulting contract; or
- Jobs for former employees.

If any of these, the seller should proceed very differently than if the answers are:

- Top price for shareholders;
- No tails; and
- Buyer assumes as many liabilities as possible.

Once the seller and its professionals have a common understanding of the definitions of value and success, they can proceed toward a transaction, even though they may need to refine the definition of success as the transaction proceeds to work toward maximizing the seller's highest priorities.

3. REALIZING VALUE • Get good advisors. The sale of a troubled small business is a regular business sale, squared. The seller of a troubled business is faced with all the issues of selling a healthy business but has additional, novel concerns to juggle based on the business's condition and the divergent interests of equity, management, secured and unsecured creditors, owners with personal liabilities, and employees. The seller is also working against a quickly ticking clock, which requires it to make decisions with imperfect information under pressure from parties whose interests are not aligned with the seller's. Well-counseled sellers can survive and even prosper. Figuring out what kinds of advisors, and the right advisors, is necessary and can make the difference between success and disaster.

As with any sale, advice is essential. Lawyers should stay out of nonlegal areas. Financial advisors and investment bankers are good at valuing and marketing a business and financing a sale. Crisis managers, of whatever name, are often essential

when holding a business together long enough to sell. Explore the legal options. Lawyers are best at navigating the legal options and determining where liabilities and proceeds come to rest.

Understand The Basics

As in every sale, identify what is being sold, who holds title, and what assets are subject to security interests. Often, there are two valuable assets that belong either to the seller, or some individual employed by the seller: non-competition agreements and consulting agreements. Select a process through which the sale will be completed. There are a small number of options.

Non-Judicial Sale

Non-judicial sales are confidential, fast, and inexpensive. The limitation of non-judicial sales is that a seller cannot sell what it does not completely own and many buyers do not want to buy without more assurance of getting good title. Absent consent from all parties whose rights would be compromised, a normal sale is impossible. This sort of sale does not provide a forum for discussing the personal liabilities of individuals.

Just Walk Away

Potential sellers of assets from distressed businesses assume that they are obligated to “do something” with the assets. If owners will receive nothing, they are not required to proceed with any sort of sale. They can simply hand the assets over to their secured creditors. They may want to negotiate a trade of their assistance with an orderly shutdown or help with a sale for enough cash to take limited actions that will protect themselves either as a legal or as a practical matter, such as terminating employee benefits plans and making sure mail is answered for a limited period. In that case, unsecured creditors take their lumps. The primary downside is that any personal liabilities of owners or management, such as guaranties or trust fund

taxes, remain unchanged. This is an area in which counsel must be very clear about the borders of the representation, and owners, officers, and directors should be encouraged to obtain separate advice. Those with personal liabilities sometimes prefer to take part in liquidation in order to minimize their exposure.

Assignments For The Benefit Of Creditors (“ABC”) And Similar Arrangements

The general concept of an ABC or equivalent is that it creates a less expensive alternative to bankruptcy. Most states have some form of ABC practice. In many, the ABC laws have been enacted to offer a less expensive alternative to a Chapter 7 bankruptcy. In general terms, the company transfers its assets to an assignee who deals with those assets in a relatively transparent process designed to let the assignor walk away from the business and for the creditors to feel they are being fairly treated. ABCs are inexpensive, relatively confidential, and relatively quick. The downsides are that any individual creditor can start litigation, no easy forum exists to resolve issues related to title, liens, or personal liability, and there is no automatic stay as in bankruptcy, so any group of creditors can file an involuntary bankruptcy, defeating the goals of speed and reduced cost.

Judicial Options

For our purposes, the benefits of either form of bankruptcy are several:

- Filing creates a “bright line” about when the former business came to an end and the parties’ rights were fixed;
- The automatic stay provides breathing space to methodically analyze the potential for selling a distressed business;
- The process is public, generally relieving management from accusations of insider dealing;

- The sale process is usually by competitive auction. Some buyers may be put off by participating in a public auction, but the process may result in higher prices than the private sale of a troubled company;
- Issues regarding title to assets and interests in the business can be resolved; and
- Finally, personal liability issues cannot be resolved, but there is a forum to identify and discuss these liabilities.

The burdens are significant:

- Bankruptcy, and Chapter 11 in particular, is expensive;
- The process is often adversarial;
- The process is public; and
- The process takes time, which in itself costs additional money.

Pressures That Guide Decisionmaking

In the sale of a troubled business, three pressures significantly affect the decisionmaking process:

- *Time.* Absent money, time is the seller's enemy. Selling a troubled business is like evacuating a building in the path of a fire. You need to keep a clear head, avoid panic, and use time wisely;
- *Money.* Absence of money creates or deepens most problems. Even if payments are current, lenders may declare covenant defaults, increasing interest-to-default rates and limiting or precluding further advances while funds paid into the lenders' accounts may be swept to repay existing balances. Unless owners are willing simply to feed the kitty to keep the company running until a sale can be concluded, any money the seller can obtain will come at a premium price or on difficult terms. Some creditors have a vested interest in a business's survival, others do not;

- *Potential litigation/threats of litigation.* If the business is unable to pay on normal terms, creditors may threaten or even commence litigation. At the least, this is distracting and comes at a time when management needs to focus on sale of the business. Once a creditor commences litigation, the seller may be forced to file a bankruptcy case in order to stay, or "freeze," the litigation.

Players: Understanding

Promotes Positive Outcomes

Players in the sale of a troubled business are typically motivated by pain and risk avoidance.

Lenders

The lenders' willingness to work cooperatively depends in part on the type of entity the lender is. In general, lenders want to be paid sooner rather than later and may be unwilling to work toward a going concern sale because of the time, cost, and risk involved in continuing to operate:

- *Banks.* As one longtime banker used to say throughout nearly every meeting with troubled borrowers, "My bank gave you money; it just wants to be repaid. Soon." Regulation limits banks' flexibility, regardless of the business solution that might seem to other parties to create the most value;
- *Factors.* Factors typically have little patience and enforce their remedies strictly. However, they will stay in the game as long as they believe the business can survive;
- *Hard money lenders.* Also willing to hang on, if the rates are high enough and the business has any hope;
- *Other lenders.* Venture funds often disappear when a company becomes seriously troubled. Hedge funds may have the flexibility to work with borrowers or take control of a company, rather than simply collect a debt.

Family Members

Selling a troubled family business raises issues ranging across legal and other specialties: family law, family relationships, succession planning or lack thereof, tax law, and emotional issues regarding money, self-image, and change. Relatives who never seemed to care about the business may suddenly express uninformed but passionately held opinions. Older generations may have difficulty coming to terms with younger generations' inability to carry on their elders' dreams. Family members may be unwilling to give up cushy jobs. When the call goes out for someone willing to roll up his or her sleeves and run the company, everyone may just take a giant step backward. An understanding of family politics and inter-generational issues can prove invaluable.

Employees

Mass employee defection depresses value. Key employees may be crucial to a halfway successful sale. If pursuing a going concern sale, keep employees motivated. Employees may quickly become

uneasy with the concept of a pending sale, with or without a bankruptcy.

Buyers

Buyers of troubled businesses generally want good prices, little cash up front, few assumed liabilities, and time for reasonable due diligence.

4. DELIVERING VALUE • When all is said and done, evaluate your results:

- Was an environment created in which the issues facing the small business were addressed and resolved, whether financial, familial, or otherwise?
- Was maximum value obtained for the assets?
- Were issues of personal liability identified, addressed, and resolved?
- Was something “left on the table” for the former owners, such as a consulting or non-competition agreement?
- Will your clients live to fight another day? As Dr. Spencer Johnson said in *Who Moved My Cheese*, “There is always more cheese out there.”

PRACTICE CHECKLIST FOR

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- Identify the decisionmakers. The managers or owner/managers of a troubled company may not be the appropriate decisionmakers owing to conflicts of interest.
- Determine value. (The seller's primary value expectations, what the seller has that the market will pay for, and whether there is a strategic solution.)
- Realize value. Select a process through which the sale will be completed. There are a small number of options: non-judicial sale, just walking away, assignments for the benefit of creditors (“ABC”) and similar arrangements, and bankruptcy under Chapter 7 or Chapter 11.
- Deliver value. When all is said and done, evaluate your results. Was maximum value obtained for the assets? Were issues of personal liability identified, addressed, and resolved? Was something left for the former owners, such as a consulting or non-competition agreement?