By Geoffrey L. Berman[1]

Sales of Assets by an Assignee for the Benefit of Creditors

Should Such a Sale Rise to Level of a Fraudulent Transfer?

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A sale of substantially all of a debtor's assets by an assignee for the benefit of creditors has become a fairly common occurrence. The question of whether a general assignment is really a tool for insolvent debtors to affect a fraudulent transfer of its assets has been an issue that has and continues to lurk near the top of the issues potential assignees are asked about almost every time they are approached to consider such an assignment and an immediate sale of assets.

An increasing number of businesses have asset-based loans with debt levels exceeding the realizable value of the underlying assets. Practitioners who act as assignees are seeing the following fact pattern on a frequent, if not almost every deal, basis:

- The proposed assignor owes the secured lender millions of dollars;
- The value of the collateral is nowhere near the level of debt;
- The lender has grown tired of continued financing of the business;
- There are limited interested parties willing to come in and finance the business or, in the alternative, acquire the assets;
- Unsecured creditors are threatening litigation, litigation is ongoing or a judgment has been obtained;
- The principals of the business are considering starting fresh and want some protection from paying the significant unsecured debt the business has run up; and
- A general assignment is proposed as a mechanism to sell the assets (to themselves), without court intervention and to enable the "fresh start."

The problem is this: How does an assignee ensure that the assignment and sale are not deemed as a fraudulent transfer on review by a court *after the assignment and sale have taken place*? As in every case, *facts* make a difference; any significant change in the facts of your case will potentially change the outcome once a trier of fact is looking at the matter.

As a starting point, general assignments for the benefit of creditors (ABC) have been recognized as a legitimate liquidation procedure by courts for nearly 100 years.[2] "An [ABC] is a business liquidation device available to an insolvent debtor as an alternative to formal bankruptcy proceedings," and the "assignee in a general [ABC] essentially stands in the shoes of a bankruptcy trustee."[3]

The context for a fraudulent transfer, of course, is the applicable state's codification of the Uniform Fraudulent Transfer Act (UFTA).[4] One also needs to consider the definition of "assets" under the UFTA. An "asset" means "property of the debtor, but does not include...(1) *[p]roperty to the extent encumbered by a valid lien*."[5] If all assets of the debtor are encumbered by a valid lien and the value of the collateral is less than the amount of the underlying debt (*i.e.*, the secured creditor is "undersecured"), an assignment and a subsequent sale by an assignee with the secured creditor's consent cannot, by definition, be a fraudulent transfer. If, however, the secured creditor is oversecured, there would be "assets" involved in a transfer that would be subject to a fraudulent-transfer claim. Assume the following underlying facts to an assignment and sale:

- A general assignment is made to the assignee, who immediately sells all of the assets to a third party;
- The assignor (debtor) was obligated to a third party who asserted a perfected security interest in all of the assets of the assignor;
- The alleged secured creditor consents to the general assignment conditioned upon an immediate sale to a buyer that the alleged secured creditor approves and which has as a principal a former insider of the assignor; and
- The sale does not retire the secured creditor debt. The assignment is made and the sale consummated by the assignee.

Is this assignment and sale a fraudulent transfer? Without more information, there is no way to determine whether the sale is in fact a fraudulent transfer. The sale is to a (former) insider; it is a sale of all, or substantially all of the assignor's assets; the sale is for value that the secured creditor deemed satisfactory to release its lien (assumed for this purpose) but not necessarily sufficient to generate a recovery by unsecured creditors; and the sale was a transfer of

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2 *See Brainard v. Fitzgerald*, 3 Cal.2d 157 (1930), and *Credit Managers Assn v. National Independent Business Alliance*, 162 Cal.App.3d 1166 (1984), and statutory support dating back to the early 1900s in states such as New York and New Jersey.
3 *Credit Managers Assn. v National Independent Business Alliance, supra.*
4 For the purposes of this article, as embodied in the California Civil Code § 3439, *et seq.*
5 California Civil Code § 3439.01(a) (emphasis added).

the "essential assets of the business," though not to a "lienholder who then transfers the assets to an insider."

One has to look at the other factors in play. First, is the alleged secured creditor truly secured with a perfected lien on the assets? It is an assignee's fiduciary responsibility to validate the alleged secured creditor's lien rights. If the creditor is not properly perfected in the debtor's assets, then the assignee's lien rights would make the alleged secured creditor junior to the assignee and equal with all other unsecured, non-priority creditors[6] and make the "assets" subject to the fraudulent-transfer statute.

Assuming the alleged secured creditor has a perfected lien and therefore has rights greater than that of the assignee, the assignee must obtain the secured creditor's consent to the making of the assignment, taking possession of its collateral and then liquidating the collateral. Otherwise, the assignee could be considered to have converted the secured creditor's collateral and be subject to a claim for any damage caused to the secured lender. More importantly, because the "assets" sold are not property of the debtor under applicable UFTA statute(s), there cannot be a fraudulent transfer.

Turning next to the question of whether the sale by the assignee to a buyer that included a former insider is appropriate, one must review the value of the assets assigned and then sold. In my base facts, I noted that the sale was for less than the secured debt. How much the secured debt is at the time of the assignment and sale, the reasonable value of the assets and whether the debtor has previously tried to market the assets for sale are all factors to be considered. For example, if the assets are worth $5 million as established through some meaningful valuation and/or sale process, and the secured debt totals $40 million, regarding the question of whether a sale by an assignee for $5.2 million (or less than $5 million for that matter) is reasonable, there is hardly much to discuss. Even if the sale were to an insider, the fact that a properly perfected secured creditor was willing to release its valid lien for the amount paid for the assets should end the inquiry. If a buyer could be found who might pay twice the amount paid for the assets, it still would not come close to satisfying the secured creditor's claims. If the assets were worth $40 million and had not been shopped, then a sale to an insider might be subject to serious questioning.

Whether the general assignment was made to hinder, delay or defraud creditors also calls into question the impact of statutes that govern the treatment of prejudgment remedies (where applicable) such as writs of attachment or protective orders. California's legislature has enacted mechanisms to terminate writs of attachment issued within 90 days of the making of a general assignment and that terminate a lien of a temporary protective order issued within 90 days of the making of a general assignment.[7] Further, at least in California, there is specific statutory support for the making of a general assignment, found in the Code of Civil Procedure § 494.020 ("Notwithstanding any other provision of this title, the defendant may make a general [ABC].").

Returning to the question of whether the assignment and sale are actually considered a fraudulent transfer, when one examines the impact of the Code of Civil Procedure §§ 494.020 and 494.030, an assignment and sale should be safe from attack, unless the *facts* of the particular matter are so egregious as to reach a contrary conclusion.

If an assignee fails to fulfill its fiduciary obligations, fails to investigate and confirm the validity of an alleged secured creditor's lien(s), and/or fails to give notice to creditors as required by statute or honor the priority of creditor claims by reason of state or federal statute,[8] then the assignee bears the risk of claims from creditors where it is otherwise not liable for the debts of its assignor. Assignees often get approached in advance of accepting the general assignment so that they can in fact be prepared to assess values through an assignment and immediate sale. That requires being able to validate the alleged secured creditor's lien and perfection, by reaching an agreement with that lender conditioned on the making of the general assignment, an analysis of the assets to be sold, the marketing of those assets preassignment and the involvement of insiders of the debtor in any subsequent buyer. These actions by and of themselves do not rise to the level of participation in a conspiracy or involvement in a fraudulent transfer. Move away from common sense, good custom and practice, and the door can open for a court to find in fact that an assignment and sale are indeed considered a fraudulent transfer.

So what should assignees, their counsel and parties to these types of sales take from this? The inherent risks of an assignee accepting a general assignment and then immediately selling the assets remains high and subject to post-sale review. Process is in fact important, if not an overriding necessity. Therefore, a prudent assignee should make sure to address the following points in planning and carrying out a proposed general assignment and sale of assigned assets.

- The assignee *must* confirm the validity of any purported secured creditor by obtaining a certified lien search with the applicable Secretary of State's office[9] to determine the nature and extent of all liens of record against the assignor's assets, including tax liens and judgment liens, and be prepared to assert its lien rights where the purported secured creditor is not properly perfected.
- Depending on the nature of the assets involved, the assignee should consider the existence of so-called "secret liens" that do not show up on any lien search such as PACA liens and warehouseman's liens.
- The assignee *must* ensure that the amount of the secured claim is documented and substantiated.
- The general assignment must have been properly authorized by the requisite corporate authorities.
- An appraisal of the liquidation value of the assets should be conducted to establish a degree of comfort that the price for which the assets will be sold is in excess of what a trustee could obtain if the assets were sold in a chapter 7 proceeding.[10] Most experienced assignees try to achieve a sale price

6 An assignee has the rights of a lien creditor pursuant to the Uniform Commercial Code, as enacted in all 50 states and without taking any further action to perfect those rights. In California, that right is found at Commercial Code § 9-309(12). The security interest itself does not necessarily "secure" anything, but it effectively blocks creditors with not-otherwise-perfected lien claims against the assignor from improving their position post-assignment.

7 *See* California Civil Code § 494.030.

8 A number of states, where general assignments are court-supervised by statute, require court approval of the liquidation of assets and typically have a notice provision requiring the assignee to give notice of the intent to sell assets (excluding perishable inventories for example) before any such sale is made. *See* Florida Revised Statutes § 727.111.

9 The appropriate Secretary of State's office for checking filed liens is now the office in the state of incorporation, which is not necessarily the state where the business or its assets are located.

10 If time permits, efforts should be made to market the assets to other potentially interested buyers. However, in most cases time will not permit this process, but the assignee could gain a lot of comfort if some effort was made to locate other buyers.

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of at least 10 percent above the appraised liquidation value. This will be significant if an involuntary bankruptcy proceeding is commenced by disgruntled creditors. The assignee, who will have retained counsel to confirm the validity of the purported secured creditor liens, will then have to have counsel initiate proceedings to have the bankruptcy court abstain or have the case dismissed. If the sale is to a buyer who might be considered an insider, the percentage excess should be as large as possible.[11]

• The secured creditor must agree to the proposed sale (remember, there is nothing that "requires" a secured creditor to consent to release its lien except for sufficient value being generated to retire the secured creditor's lien).[12] This is another reason why an appraisal, or some other method of determining the value of the assets being assigned and sold, is necessary to establish that the sale proceeds that will be paid to the secured creditor reasonably represent what that creditor would receive if it had foreclosed and conducted its own sale.

• The buyer should be an arm's-length buyer paying fair value for the assets, and where the buyer is an insider or related party, the purchase price should be tested in the public marketplace so as to ensure the best price for the assets.

• The buyer must acknowledge that the assets are being sold "as is, where is," with all faults and without representations or warranties of any kind. The assignee can only sell that right, title and interest in the assets that were obtained from the assignor. Typically, an assignee will warrant that it is acting as an assignee for the benefit of creditors with the right and authority to sell the assets, and nothing more.

• If anyone to that process (the principals of the debtor, the buyer or the lender) objects, the sale process should be revised to clearly identify the risks and generate the fairest and best value possible.

• Lastly, sufficient funds must be available from the assignor or secured creditor so that due diligence can be done by the proposed assignee without having the proposed assignee act as a "consultant" to the debtor. Such preassignment retention theoretically taints the consultant to the point where he or she cannot be considered "disinterested" (especially if he or she have not been paid for preassignment work) and therefore act as the fiduciary for creditors.

If done properly, an assignment and sale should not be considered a fraudulent transfer, but failure to protect the process can and should lead to breach-of-fiduciary-duty claims against the assignee, for it is the assignee who failed creditors. abi

11 A liquidation appraisal may not be necessary based on the facts of the particular matter if, for example, a financial adviser or investment banker was hired before the assignment process was initiated whose efforts did not generate any interest at the levels necessary to bring about increased recovery from the assets.

12 If the secured creditor is willing to agree to set aside some portion of the sale proceeds for unsecured creditors, and depending on the facts presented, there may be a reason to discuss the potential assignment with certain of the assignor's major unsecured creditors. However, this should only be done in the rarest of cases where the threat of an involuntary bankruptcy is readily known and in an effort to prevent that involuntary bankruptcy petition being filed before the assignment is made and accepted.