

A Better Alternative to Business Bankruptcy

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You are sitting in your office and an associate counsel comes to you. The company is facing an immediate liquidity crisis and is looking for advice. For general counsel of private equity or venture capital firms, assume that the scenario is the same but the entity in question is one of the firm's portfolio companies. You deal with a host of issues company-wide, but avoiding a bankruptcy or a wind-down is not your sweet spot.

The company is a Delaware corporation and has secured debt of \$10 million, with mezzanine debt of another \$10 million plus an equity stake in the company. The board includes the mezzanine debtor. Revenues are less

than projected. The company has been hemorrhaging money by the tens of thousands weekly. Your assets are almost all patents and other intellectual property developed for your product. What do you do?

First, you should consider contacting bankruptcy (or insolvency) counsel. It is important to have the right advisor and to make certain that the fiduciary responsibilities of the board of directors are revisited at this time.

Recognizing the desire to avoid the publicity and the relatively high cost and manpower of a bankruptcy, what other alternatives do you have? Assume that the secured lender has been cooperative and doesn't want to liquidate

its collateral, which includes all the intellectual property. Your outside counsel raises the possibility of making an assignment for the benefit of creditors (an ABC). Great, but what is an ABC?

AN ABC IS A STATE PROCESS

An ABC is a state law process to liquidate the assets of a business. Each state has rules or statutes that govern the process. It is not a bankruptcy, as bankruptcy is governed by federal law.

ABCs can be done under court supervision in states such as Delaware and Florida; turned into a receivership action as in Minnesota, North Carolina and Washington State; or done as an out-of-court process, as in

California and Illinois. No matter what rules govern, the process itself is straightforward. A person or firm experienced in administering ABCs is chosen by the company's board of directors (or members per the operating agreement of an LLC). The board's action needs to be ratified by a majority of the shareholders. The board, in making the decision to

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liquidate, will want advice from outside counsel to protect exercising its business judgment to make the ABC and the choice of the assignee.

Once the ABC has been authorized and shareholders have consented, the company will execute a form of trust agreement called a General Assignment or Trust Agreement. (Based on applicable state law, it's a distinction without a difference.) This is the contract transferring all rights, title and interest in the company's assets to the assignee. The assignee is a fiduciary, responsible for liquidating the assets and distributing them to the company's creditors.

With the secured creditor in our example, the assignee will want the secured lender's "consent" to liquidate the lender's collateral and to be paid for its service as assignee. The assignee will have to validate the lender's security interest to be able to affirm to creditors and an applicable court that the lender's lien is properly perfected.

In our example, the intellectual property has some interest from

third parties, but nothing that will likely get the secured lender and the mezzanine debt paid in full. The assignee will try to find parties interested in the intellectual property portfolio. How that is done depends on many factors including, for example, pre-assignment marketing of the company, interest from insiders to the company, and so forth.

We will assume that two parties express interest in using the intellectual property portfolio, and that the mezzanine debt holder is one of the interested parties. In this scenario, the assignee will conduct an auction-type sale where the parties can bid against each other on terms that are similar for both. No "credit bidding" will be allowed, and the bids are all cash. At the conclusion of the sale, the high bidder is declared, and the money is paid to the assignee. A bill of sale is executed along with the necessary transfer documents and a release of the lenders' liens. The assignee will use the proceeds to complete the liquidation and pay the creditors according to a "waterfall" based on the priorities established by law.

ABCS ARE FLEXIBLE

This simple example shows the flexibility of the ABC process.

Where the process is court supervised, it is a bit slower, as the sale is governed by motion practice. Otherwise, it is close to what you think of in a bankruptcy sale.

Creditors are generally amenable to the ABC process because the assignee provides creditors with a Notice of the ABC and a place to file claims. A good assignee will make sure to attend to the creditors' concerns and timely respond to questions. Most accounting departments are familiar with claim forms either

from a bankruptcy court or from an assignee for the benefit of creditors. The fact that a wind-down process is being done by a reputable third-party fiduciary goes a long way to making this process work.

Similar to a trustee in bankruptcy, an assignee is not liable for the debts of the assignor company. However, the assignee must use its business judgment to try to maximize the asset value for creditors.

One other point of interest for the company's general counsel: Bankruptcies are reportable by board members who serve on a public company board. ABCs have generally been deemed not reportable because they are not a bankruptcy. It is another key advantage to this alternative.

Your outside insolvency counsel can refer you to resources that will help you learn more about an ABC, as well as refer you to assignees who can answer questions that are general or specific. Most importantly, knowing about the alternative will help you address your specific issues as they arise.



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