



*Leading Distressed to Success*

## **Changing Control of Assets Using Article 9 Tool**

**This report has been prepared solely for information purposes. This presentation is not intended to be legal advice.**

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# Changing Control of Assets- Zone of Insolvency

The popular options:

- Chapter 11 bankruptcy case.
  - A federal court process.
    - Section 363 sale
- Assignment for the benefit of creditors (ABC)
  - A state governed process.

An overlooked alternative:

- Article 9 Foreclosure Sale.
  - Conducted according to UCC statute.



## Article 9 Foreclosure Sale Definition

- A process conducted under the Uniform Commercial Code (UCC).
- The foreclosure on secured assets by a lender and simultaneous private sale to a prearranged third party or simultaneous advertised public auction.
- Generally a debtor co-operative transaction.
- Used in “loan-to-own” transactions.
- Used to transfer control when the secured is out of the money.



## Why Use an Article 9 Transaction?

- This is an out-of-court process.
  - Faster.
  - Less costly.
  - No competitive bidding.
- It is a good way to preserve going concern value.
- The third party to whom the assets are sold may have an interest in the outcome.
  - Management led buyout.
  - Or a large unsecured creditor.
- Company has previously been marketed without success.



## Appropriate Circumstances for an Article 9

- A cooperative debtor.
- The secured lender is “under-secured”.
- The going concern value is in excess of asset realization liquidation (but still less than the secured claim value).
- The company has been broadly marketed and there are no buyers.
- The company is too fragile for bankruptcy.
- Key employees and management want to continue the business.
  - And the customer base will continue to support the enterprise.

### Circumstances where an Article 9 Foreclosure Sale is **NOT** appropriate:

- Where real estate is involved (note: UCC does not apply to real estate).
- Where key employees and management can easily establish a competing business without the assets of the debtor.
- Solely as a tactic to eliminate unsecured creditors.
- Any kind of environmental issues – need to consult counsel on chain of title issues.



## Article 9 Process

- Transaction must be “commercially reasonable”.
- Limit “Successor Liability” issues.
- Give unsecured creditors a reason to cooperate.



# Commercially Reasonable

- Maximize sale price and value from collateral.
  - Document previous efforts to sell the business or assets.
  - Order (or update) appraisals of receivables, inventory and equipment, if time permits.
  - Use testimony about values from senior executives.
- Must provide sufficient notice to interested parties such as junior lien holders (Time and breadth of parties can vary by state).
- Secured lender must have valid and perfected liens.
- A sufficiently advertised public sale is presumed to be commercially reasonable.



# How to Limit Successor Liability

- The buyer should NOT agree to assume liabilities or create a de facto merger or consolidation with the buyer.
  - Explicitly provide in the foreclosure agreement that the buyer will NOT assume any of the borrower's liabilities.
  - The new entity should not pay any accounts payable of old entity (do not make side deals) – vendors all talk.
- The buyer is NOT a “mere continuation” of the purchased business.
  - New Federal Identification Numbers (when preparing new Government forms, indicate a new business is being formed, NOT a continuation of the old business).
  - External appearances are important, for example:
    - Change/modify the name.
    - Negotiate new real estate leases.
    - Set up new website, phone listings and signs.
- The transaction is NOT an attempt to defraud creditors.
  - Buyer MUST give adequate consideration for the sale.
  - Provide funds to minimize issues with unsecured creditors.



# Unsecured Creditor Issues

- Even though they are “out of the money” unsecured creditors can create substantial problems.
  - Initiate involuntary bankruptcy proceeding.
  - Will not give trade credit to the buyer.
  - Challenge the sale value – sue for fraudulent conveyance.
- Provide some funds to Debtor/Seller for the following:
  - Some distribution to trade creditors – set up money in trust that can not be garnished.
  - Winding up the affairs of the estate, for example:
    - Final tax returns.
    - Final payroll, payroll taxes and employee benefits e.g. termination of 401k plan.
    - Final sales taxes.
    - Professional fees.
- Insure that the Debtor/Seller has a quiet death.
  - Appoint a friendly liquidator.
  - Avoid Chapter 7 filing and the potential for getting an aggressive Trustee.



# Case Studies



## Case Study Company A

- The company's stock was in the hands of Hedge Fund A and Sr. Lender B by virtue of a prior restructuring.
- After selling a U.K. subsidiary and the U.S. real estate (the 2 most valuable assets) Hedge Fund A and Sr. Lender B wanted to sell the remains of the company.
- Two independent appraisals of the assets indicated that the lenders were approximately \$20.0M under secured.
- The largest and only significant unsecured creditor was a captive Chinese supplier.
- The only buyer to emerge was the management group two generations removed.



## Case Study Company A cont.

- Price and date were negotiated and an Article 9 sale was selected.
- Because the loan was left in place, A&B were both lenders and equity.
  - They were going to have to foreclose on themselves to sell the assets.
- At the 11<sup>th</sup> hour the buyer walked away from the deal.
- The lenders/equity immediately began to liquidate.
- The lost buyers set up a competing company.



## Case Study Company A cont.

Through the course of the liquidation it became clear that the lost buyer had colluded with employees and the Chinese supplier to divert orders that could have been processed in the liquidation and a terminated employee had been taking mail containing purchase orders.

The lenders filed a civil suit against the prior employees for theft and threatened the employee who had tampered with the mail with Federal prosecution. This forced everyone back to the table. A price was negotiated, higher than the original and the Article 9 sale consummated.

**End Result:** Successful Article 9 Sale

**Lessons Learned:** Sale must be conducted in a commercially reasonable manner.



## Case Study Company B

- \$60 MM plastics manufacturer with 3 divisions.
  - Two had similar manufacturing technologies.
  - There were no overlapping customers or markets.
- Company had been in hands of an IB for one year.
- Offers had been deemed inadequate by the board.
- Secured lenders were impatient.
  - \$16.8 MM in debt.
- Sub-debt \$7.8 MM.
- Trade debt \$5.5 MM.
- Most recent liquidation estimated at \$15.0 MM.



## Case Study Company B cont.

- One last canvas of potential buyers was conducted.
- Two buyers emerged.
  - A buyer for one division.
    - Existing management
  - Another for the remaining two units.
    - Two managers backed by a sponsor.
- Both agreed to Article 9 transactions for speed and cost.
- Transaction 1 was successfully concluded on schedule.
- Transaction 2 failed.
  - The buyer became uncomfortable with successor liability issues.



## Case Study Company B cont.

- The company filed Chapter 11 and the two divisions were sold in separate “Section 363” sales.
  - One to a strategic buyer, the other to a distressed sponsor.
- The net recovery was \$16.5 MM.
  - More than the estimated gross enterprise value at the beginning of the process.

**End result:** Successful transactions.

**Lessons Learned:** A sale process can take multiple forms and buyers need good advisors for Article 9 transactions.

# Cratos Advisors

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**Please contact our Managing Partner, Ron Turcotte with any questions  
or to discuss how Cratos could assist you and your clients.**

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