Making Deals in the Wild, Wild West: Going-Concern Enterprise Transactions in State Court Receivership Proceedings

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In certain situations, the sale of an operating entity as a going concern in a receivership proceeding is a viable alternative to seeking relief under the Bankruptcy Code. Receivership going-concern sales may be especially appropriate in complex situations where enterprise value is declining, but the company is not hopelessly insolvent. This article briefly highlights those conditions, factors, situations and circumstances that may contribute to or impede a successful going-concern transaction within a court-supervised commercial receivership.

Type and Purpose of Receivership

The factors outlined in this article are derived from IronHorse LLC's recent experience in facilitating two very different going-concern sales.

The first sale involved a company that was a distressed, underperforming specialty wholesale distributor in transition within a very robust, healthy and growing industry and market. This entity had roughly $30 million in annual revenue, low customer or key product concentration risk and intangible value derived from its brands, strong executive team, organizational capability and distribution network. The owner (and founder) was highly supportive, open and healthy, but ready to exit the business. There was a single secured lender with a cross-collateralized line of credit, equipment term and real estate facilities. The owner and the lender maintained close and frequent contact, and the company had a history of timely and credible financial reporting.

The second sale involved a company in a much different situation. This company was a badly impaired commodity manufacturer experiencing a protracted period of decline in a very unattractive industry. The industry generally experienced very high rates of product obsolescence, business failure and entity contraction. This company suffered from a very nasty and prolonged dispute between the co-equal owners dating back five or more years. Resulting litigation had reached an impasse, and each party ultimately agreed to the

appointment of a receiver. The single secured lender, who was prepared to foreclose and liquidate the collateral, provided very stringent, "qualified" support. IronHorse LLC was appointed as the receiver, and the court allowed for a timeframe of 45 days to close a going-concern sale, otherwise the company would be liquidated.

The facts of the second situation posed substantial hurdles to conducting a thorough solicitation and sale process. The perception of fairness in the sale process was of particular concern, especially due to the pre-existing, protracted and highly contentious nature of the ownership dispute, the existence of several dozen trade creditors, substantial balances of delinquent/unpaid taxes of various types, the estate's administrative insolvency, and the abbreviated sale timeline (which ultimately resulted in an insider sale transaction.)

Creditor Considerations

An analysis of the creditor mix, make-up and history is essential in any turnaround engagement, but especially so where a company explores alternative solutions utilizing state receivership laws. Important creditor-related considerations include:

- Number of secured creditors, loan and collateral structures, and the history and strength of the lender relationship.
- The increased flexibility, influence and control potentially exerted by a secured creditor driving the receivership process versus the same concerns within a bankruptcy proceeding.
- Existence of a comprehensive state receivership statute, including filing procedures, noticing requirements, timing, etc.
- Unsecured trade creditor make-up, including aged balances owed and the availability of additional working-capital funding within receivership.
- Absence of debtor-in-possession provisions within receivership otherwise available in chapter 11.
- Secured lender's preservation of rights to collateral, including foreclosure rights, as most state receivership statutes do not provide for an automatic stay, which is otherwise available in chapter 11.

In addition, a secured lender's willingness to support a process to solicit and secure going-concern interest depends largely on:

- A well-planned, highly efficient and orderly process, including a targeted and expedited sale process driven to a timely close, with the lender's active involvement and approval throughout.
- Reliable forecasts, projections and assurances that the lender's collateral position will not be further materially impaired beyond what its net realization would be under a foreclosure or bankruptcy proceeding.
- Early, accurate identification and reconciliation of priority tax claims to their respective collateral interests. It should be noted that taxation systems vary significantly from state to state.
- Frequent, open and direct communications with the receiver to monitor expected net recovery, weekly cash requirements and sale process progress.
- Perceived protection and cover from the receivership structure, in particular within a fair, albeit expedited, sale process.

Although there may be a desire to investigate potential related party transactions and other state law claims, that process has to be funded, usually by the secured lender. In the event of an administratively insolvent receivership estate, however, the secured lender may not offer up the funding. This is particularly the case when the secured lender desires an expeditious conclusion to the receivership in an effort to minimize the possibility of adverse actions by trade creditors and other parties in interest.

Critical Factors Conducive to a Successful Transaction/Outcome

From the two receivership experiences cited above, we have compiled the following list of factors that may increase the likelihood of a successful going-concern enterprise transaction and potential pitfalls in a receivership proceeding.

Factors potentially increasing success:

- intangible and strategic assets with verifiable, realizable and substantial value
- a healthy industry
- simple ownership, legal entity, nexus and capital structures
- credible, transparent and cooperative relationship history between debtor and lender
- a viable core business
- the existence of a sufficient supply of experienced, savvy and capable special-situation financial or strategic acquirer prospects
- a limited history of insider disputes, contentious dealings or litigation (owner impasse receivership may not be the best candidate for a going concern transaction depending on other factors)
- a well-managed, well-planned and timely sale process with rigid adherence to milestones, contingencies and deadlines
- an experienced, decisive and astute court venue with expertise in highly complex financial cases
- demonstrated industry experience and expertise on behalf of the receiver, successful mergers and acquisitions track record in special situation transactions, and ample relationships and contacts with each potential strategic or private equity acquirer.

Potential pitfalls in receivership proceedings:

- highly litigious, aggressive and well-funded stakeholder willing and able to challenge every aspect of the receivership process
- inexperienced, hesitant court venue operating with minimal definitive procedures, requirements and statutory guidance, increasing the likelihood of adversarial filings by parties-in-interest
- responsible party exposure to receiver for unpaid *ad valorem*, sales, use, payroll and withholding taxes
- taxing authority priority claims on sale proceeds that were unknown prior to sale consummation that arise after the receiver begins distributions
- unfamiliarity with state law regarding transferring assets free and clear of all liens, claims and encumbrances. As previously noted, state laws are not identical. Minimizing the possibility of post-closing tail period claims, particularly when the transaction is consummated with an insider, requires clear documentation of the transaction's effect and the court's approval of the transaction.
- material weakness in internal controls, which may preclude expedited due diligence and an orderly transaction closing. The debtor's internal control environment must be assessed as early and quickly as possible, not after the execution of a "stalking horse" letter of intent.

Conclusions

Going-concern enterprise transactions within receivership are not all that common and should be considered by a thorough analysis of the particular facts, risks and other factors on a case by case basis. Those primary factors that are conducive to a successful sale under Section 363 of the bankruptcy code are typically relevant to a sale within a court-supervised receivership as well. As more states such as Missouri attempt to pass legislation providing detailed regulations, requirements and statute governing receiverships, it is likely we may experience an increase in the volume of these transactions given the latitude, flexibility and speed of process available within them.

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