

Pitfalls in Acquiring Assets from an Insolvent Company

The produce industry has been going through tough economic times for the past couple of years. Some companies have become insolvent, meaning that they can no longer pay their bills in a timely manner. When this happens, the insolvent company usually tries to liquidate its assets as quickly as possible in order to raise cash to pay off its creditors. A liquidation sale presents an opportunity to potential buyers to acquire the assets (such as farm equipment) for use in their own business operations. However, a buyer must be aware of liens on this equipment that could potentially carry over to the buyer if they purchase the equipment.

If a buyer is considering purchasing equipment from an insolvent company, the first step is to run a UCC-1 lien search with the California Secretary of State to determine if any liens have been recorded against the equipment. The lien search should be run under the exact legal name of the insolvent company. If the buyer is not sure of the legal name, then the buyer should contact the seller for its exact legal name. If that is not possible, then the buyer should run a lien search under various permutations of the seller's name. The lien search will show any and all recorded liens against the equipment.

It is important to note that a UCC-1 lien search with the Secretary of State will not identify all liens against the equipment. A purchase money lender does not have to file a UCC-1 financing statement in order to perfect its security interest in the equipment. (A purchase money lender loans money to a buyer in order to purchase the equipment). Also, trucks and other vehicles are liened through the Department of Motor Vehicles and not through recording a UCC-1 financing statement. Another important unrecorded lien is a PACA lien, which automatically attaches to a company's assets without the need to file a UCC-1 financing statement. Therefore, a potential buyer must be careful to take into account the possibility of purchase money liens, vehicle liens or PACA liens when buying equipment from an insolvent seller.

If the UCC-1 lien search or a Department of Motor Vehicles lien search shows that there are recorded liens against the equipment, then the buyer has several alternatives. The first alternative is to negotiate for lien releases from the secured creditors. This would involve the buyer paying some amount of money to each creditor in order to obtain the lien releases. If the buyer cannot negotiate lien releases, then the buyer should not purchase the equipment.

Assuming that there are no liens against the equipment or that the buyer has negotiated lien releases, then the buyer could proceed to purchase the equipment. However, the buyer should require the seller to indemnify the buyer for any third party claims against the equipment. Indemnification should protect the buyer against unrecorded liens on the equipment such as purchase money liens, vehicle liens or PACA liens. The buyer should have the insolvent company's principals (being its shareholders, members or partners) personally assume the indemnification obligation because the company is insolvent and will not be able to pay on the indemnification obligation. Even then, the buyer should

look at the individual principals' financial situation to see if they have the assets that can support the indemnification obligation.

If the buyer is going to purchase the equipment, the buyer should get an independent appraisal done of the equipment. The buyer should then purchase the equipment at the appraised value. By doing so, this will reduce the likelihood of the seller's creditors challenging the sale or from asserting that the seller and buyer are partners and trying to go against the buyer's other assets to satisfy the seller's debts.

The second alternative is for the buyer to lease the equipment as opposed to purchasing the equipment from the insolvent seller. The primary benefit to the potential buyer (who is now a lessee) is that the lessee would be able to use the equipment for some period of time without being so concerned about liens on the equipment. Since the lessee does not intend to take title to the equipment, then whatever liens are on the equipment do not carry over to the lessee. The lessee should be sure to lease the equipment at fair rental value so as to avoid any potential claims from the insolvent company's creditors that the lessee is somehow colluding with the insolvent company to defraud the creditors.

One key issue in leasing the equipment is to whom the lessee should make the lease payments. If there are secured creditors with liens on the equipment and the insolvent company has defaulted in its payment obligations to these secured creditors, then the secured creditors may (and likely do) have a priority right to the lease payments over the insolvent company. In this situation, the lessee should make the lease payments directly to the secured creditor. However, there may be multiple secured creditors with various liens on the equipment, at which point the lessee would not know to whom to make the payments. One option to resolve this situation is for the lessee to negotiate with the insolvent company to establish a segregated account into which the lessee would deposit the monthly lease payments until a designated third party instructs to whom the funds in the segregated account should be paid. This third party could be an accountant, an attorney or possibly a bankruptcy court if the insolvent company is likely to file bankruptcy. The insolvent company and the lessee would enter into a written agreement to this effect. By doing so, this protects the lessee from claims by the secured creditors that the lessee was favoring one secured creditor over another.

Neither alternative discussed above will apply if the insolvent company does not in fact own the equipment. Many companies lease their farm equipment. The owner/ lessor of the farm equipment will likely be a purchase money lender or will have filed a UCC-1 financing statement to secure its interest in the equipment. In either event, it will be a secured creditor. An insolvent company often defaults in its lease payments to the owner/ lessor. If a third party now wants to lease this same farm equipment, there are two possible ways to do this. In the unlikely event that the insolvent company is current on its lease payments and has the right to sublease the equipment, then the first alternative is for the lessee to lease the equipment directly from the insolvent company and make the lease payments to the insolvent company. The risk is that the insolvent company will not stay current (or become current) in its lease payments to the owner/

lessor. The insolvent company may end up using the money for other purposes and the lessee runs the risk of the owner/ lessor repossessing the farm equipment.

The second alternative is for the lessee to lease the equipment directly from the owner/ lessor. In order to do this, the owner/ lessor must terminate the current lease agreement with the insolvent company and repossess the equipment. The owner/ lessor must follow certain procedures under California law in order to repossess the equipment. Once it has done so, then the owner/ lessor can enter into a new lease with the lessee for the equipment. The lessee should require the owner/ lessor to indemnify the lessee for any third party claims (including claims by the insolvent company) made against the lessee for possession or title to the equipment. This will protect the lessee from any claims based upon (i) an improper termination of the lease between owner/ lessor and the insolvent company, (ii) an improper repossession of the equipment, or (iii) any claims from the insolvent company's creditors to the equipment.

There are various reasons that a potential buyer may want to purchase or lease the assets or equipment of an insolvent company. The potential buyer must proceed carefully so as to acquire good title to the assets and avoid being responsible for any of the insolvent company's debts or obligations.

Author information to include at front part of Coastal Grower:

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