

Business Update

The Legal Newsletter For Maine's Business Community

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Selling and Buying Distressed Businesses: Risks and Rewards



By David J. Perkins

In this uncertain economy, every sale of a business carries with it very substantial future legal risks. If the seller later goes into bankruptcy, the buyer can be pursued by a bankruptcy trustee on many legal theories. Even outside of bankruptcy, the buyer may inherit unexpected liabilities, such as claims from the seller's creditors, product liability claims or tax claims.

An important strategy to consider in buying a business that has some level of financial distress is to have the seller file for bankruptcy protection. A Section 363 sale can then be quickly arranged, with court approval. Most importantly, the bankruptcy court approved sale can provide that the sale is "free and clear of all liens, encumbrances and claims." Such an order is the best form of insurance a buyer can ever get to avoid claims arising from the seller's conduct of its business.

The Risks

It would be nice if a buyer of a distressed business could limit its concerns to returning the distressed business to

profitability. But that's not the case. With every sale of a distressed business, the buyer is exposed to a wide range of very nasty potential liabilities.

- **Successorship Liability:** The general rule is that a purchaser of assets for fair consideration does not become liable for the seller's liabilities. That general rule, however, may give way to many exceptions. The buyer, or "successor," may be liable for all of the seller's debts under a "continuity of enterprise theory or de facto merger theory" (liability may arise where the successor retains key personnel, operations remain the same, trade name continues in use, and some overlap of shareholders exists), express or implied assumption (if the purchase and sale contract does not very clearly have the buyer disclaim assuming the seller's liabilities, the assumption may be implied), and the product line theory (if the successor has continued the seller's product line, some courts have held the buyer liable for product liability claims that originated from products manufactured by the seller).
- **Leveraged Buyouts:** If the buyer acquires the seller's assets by using the transferred assets as collateral for

financing a substantial part of the purchase price, courts can later find the buyer, seller and even the financing bank liable under fraudulent transfer theory. Stated simply, if the leveraging of the assets of the company being transferred with new debt places the company in a position where it is unlikely to survive with the new debt, then the transaction can be viewed as a fraudulent transfer. If the business later fails, courts may view the seller and the buyer as having placed the risk of the leveraged transaction unfairly on the shoulders of the trade creditors.

- **Tax liability:** The buyer of the assets of a distressed business can also inherit the tax liabilities of the seller. For example, under Maine tax law, a successor becomes liable for any unpaid sales taxes left over from the seller's period of ownership.

The Protections Offered by a Bankruptcy Sale

When we think of Chapter 11, we often think of a very slow and expensive reorganization proceedings that provides substantial protections for creditors. But the Chapter 11 process is becoming increas-

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Challenging Times Present Opportunities and Great Risks

In this newsletter, we focus on legal issues confronting Maine businesses in these increasingly troubled times.

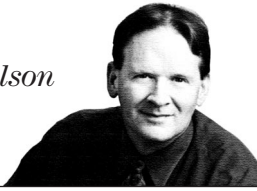
Each article is designed to help you and your firm to seek out new business opportunities, and to avoid legal traps.

On Thursday, April 16, 2003, at 7:30am, Perkins Olson, PA will sponsor a breakfast presentation on "Buying and Selling Distressed Maine Businesses." Please confirm your attendance with Noelle Forest, 871-7159.

We hope that this newsletter and the April 16th breakfast forum will provide ideas and assistance to our clients and friends who are moving forward with pursuing new business opportunities despite this difficult economy.

Ten Things To Do In A Recession

By Richard Olson



Although we do not officially know if we are in a recession until months later, after all the economic statistics are in, most of us sense when we are in an economic downturn. With a series of layoffs and business closures throughout Maine across a wide range of industries and reports of a softening of the real estate market in Massachusetts, you do not need to be an economist to know there is economic trouble ahead.

Having said that, we also know that the economy will improve again and that this downturn presents opportunities to play offense as well as defense. Here are ten ideas.

1. **Personal Asset Protection Planning.** If you have or expect to have exposure on personal guaranties or other individual liabilities remember that some assets will be exempt from your creditors. Maximize your investment in exempt assets such as home equity (up to \$25,000 for individuals and \$50,000 for couples—more for seniors). ERISA qualified pension plans such as 401k plans are completely exempt, while the exemptions for IRAs, annuities and the like are less certain. Do not roll over a 401k into an IRA without discussing it with counsel. Family assets can be held in family limited liability companies or trusts.

2. **Review or Establish an estate plan.** Death and disability are tragic enough by themselves, even worse for your loved ones if you leave your estate in confusion, especially in troubled economic times. If you do not have a will, prepare one. Review your existing will. Review your status as an heir. We are currently in a massive inter-generational wealth transfer and there are actions you can and should take to protect assets that might be left to you. While Aunt Gladys may want to leave you her nest egg, she will not be happy (in the

afterlife) to find out that the nest egg went to your creditors.

3. **Business Planning.** Does your business have an adequate shareholder agreement describing what happens if shareholders need to sell, die or are disabled? Does the company have key person insurance on the key people? Do you have a succession plan?

4. **Review and Improve your Existing Credit Arrangements.** Have you reviewed the covenants in your loan documents lately? Are you in compliance and can you remain in compliance with the ratios? If not, seek formal modifications before you need to. During the early 90s many business owners learned about their covenants the hard way—in a letter directing them to refinance or face foreclosure. The commercial loan business remains relatively competitive.

5. **Take your Banker to Lunch.** If your commercial banking relationship is important to your business, make sure that you know your loan officer and his or her superiors. Develop and maintain the relationship before you get into trouble. If your business runs into trouble and they need to make a decision, it is better for you that they associate a person with that business, that they understand your business and that they have confidence in your ability and commitment to survive a downturn. Take your loan officer to lunch, give him or her a tour of your office or plant so they understand your company's strengths now.

6. **Beware Troubled Companies.** We do not know yet how many businesses will ultimately fail with the Bankruptcies of Great Northern and the Bangor and Aroostook. Tighten up your accounts receivable and credit policies. For chronic late payers shift to cash terms until they demonstrate the ability to pay. If you are extending credit obtain a personal guaranty from the principals of the business or a letter of credit. If you are going to give products away, better to give them away as discounts or promotions to paying customers or new customers. If you have outstanding accounts be aggressive in collect-

ing, discounting if necessary to bring the cash in while it is available.

7. **Don't Unnecessarily Increase Personal Liability.** Make sure to file all tax returns when due and pay all trust fund taxes. Claims against responsible people for trust fund taxes such as withholding taxes are not dischargeable in bankruptcy. No matter how bad things get, do not give anyone false financial statements or otherwise engage in fraud, defalcation or acts that might be a breach of your fiduciary duties. Not only do you risk being sued, but those claims are not dischargeable. Remember that when a corporation becomes insolvent, your fiduciary duty shifts to the creditors not the shareholders. If you find yourself an officer or director of an insolvent corporation, you are personally in a legal minefield and need counsel. Even if there is a directors and officers insurance policy, you can not sure of coverage for either defense costs or claim coverage until the insurance company actually sees the claim and agrees to coverage. In recent years dozens of local people have learned a great deal more than they ever wanted to know about insurance law and claim exclusions.

8. **Sell a Troubled Business.** The fact that a business is troubled, does not mean that it has no value. A properly planned strategic sale of a business can minimize your personal liability and even provide you with cash and other benefits. See David's article in this newsletter for specific advice regarding buying and selling.

9. **Look for Opportunities.** For several years many people have complained that the prices of real estate and business assets has been too high. As the cycle progresses there will be more and more opportunities to buy sound businesses at reasonable prices. There continues to be capital available for investment in new and existing business.

10. **Be proactive.** Do not wait until trouble gets worse to consult with your accountant and attorneys. The earlier you act to protect your personal and business assets the better.

Maine and Federal Law Prohibit Age Discrimination By Private Employers



By Kevan Rinehart

Most employers know it is illegal to discriminate against someone due to her or his age—or do they? Absent an employment contract, most employees work “at will.” This means that employees are free to look for better offers and to resign. In return, shouldn’t this leave a private employer free, within limits, to do what she or he feels is best for her business, including firing an employee with or without cause, and without government interference?

Regardless on one’s political leanings, many employers may be shocked to learn that, under Maine law, it is unlawful for “any employer to require or permit, as a condition of employment, any employee to

retire at or before a specified age or after completion of a specified number or years of service.” 5 Me. Rev. Stat. Ann. §4574(3)(B). In laymen’s terms this means that as long as an employee of a certain age can and is completing the tasks required under a given job description, she may not be terminated. The underlying purpose of this law is to force Maine employers to evaluate employees on their job performance alone, rather than being influenced by the temptation to replace a long-term employee with a younger, cheaper model. The Maine law underscores, supplements and extends the federal law, which ceases its protection of employees who have reached age 65 and will retire with certain benefits.

The hurdle an employee must overcome when suing under a claim of age discrimination is fairly modest. He must establish that his age was a substantial, but not the only, factor, in his termination.

This is more commonly known under the law as a “but for” analysis: the employer is liable if she would not have terminated the employee ‘but for’ his age. As noted by the Maine Supreme Court, this legal standard can have real-life impact when an employer finds herself in the midst of making hard decisions in a recession or market slowdown:

Rare will be the case where an employer will be unable to identify some “reasonable ground” other than age to justify the discharge of an older employee. For example, an economic downturn might require a reduction in an employer’s workforce. If age had to be the sole factor motivating discharge to contravene the [statutory] prohibition, the employer could proceed by firing the oldest employees first without any individualized appraisal of

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Buying and Selling, continued from page 1

ingly used for conducting very quick Section 363 sales of assets of the distressed business. Importantly, the sale can be structured to protect the buyer from all types of liabilities of the seller, including the risks described above.

Section 363(b)(1) of the Bankruptcy Code simply states that the trustee (i.e., the debtor), after notice and hearing, may sell the debtor’s property.

Section 363(f) allows the debtor, after hearing and with approval of the court, to sell some or all of the debtor’s assets “free and clear” of any interest in the property.

Section 363 provides a very powerful tool for selling assets and avoiding claims. The assets can be sold, even if there are other claims to the property. Thus, claims can be stripped in the process, with the claim attaching to the proceeds of the sale. Most importantly, the claims that might otherwise follow the assets can be barred by order of the Bankruptcy Court from pur-

suing the buyer.

Unlike a Chapter 11 plan of reorganization, there is no “best interests of creditors” test, no required impaired class voting for a plan, and no absolute priority rule (which often allows secured creditors to prevent plans from being confirmed where they are not being paid in full).

The Bankruptcy Court’s order permitting the Section 363 sale is a final order that will generally control in every court in the country, provided that notice is provided to the affected parties.

The Bankruptcy Sale Process

With a Section 363 sale, the seller/debtor will enter into a contract to sell its assets to a particular buyer. The contract can not be binding on the seller/debtor until there is notice to creditors, a hearing, and approval by the court.

In many cases, the debtor will use a “stalking horse” procedure. The phrase “stalking horse” comes from the time of Shakespeare and is derived from the prac-

tice of concealing oneself behind a horse to get close to a fowl for the purpose of shooting the fowl. With a “stalking horse” procedure, the debtor enters into a contract with the buyer (the “stalking horse”), and the buyer agrees that the assets can be sold to a higher bidder pursuant to agreed upon procedures. Those procedures often involve an auction that is held before the bankruptcy judge. The purpose of the procedure is to get a binding commitment from the stalking horse buyer, and then to test the marketplace for higher priced buyers. Often, the stalking horse buyer will be allowed a breakup fee if the stalking horse buyer is outbid. For example, in the Great Northern bankruptcy case that is currently pending, the stalking horse, Belgravia, is allowed a \$5 million fee if it is outbid.

In approving Section 363 sales, the Bankruptcy Court will usually accept the business judgment of the debtor’s management in choosing the Section 363 sale, absent bad faith, questionable business rationale or a clearly flawed process.

How To Recognize A Fraudulent Transfer

Consider the following scenarios: a teacher's financial well-being is in jeopardy due to his child's medical issues; a restaurant is on the brink of dissolution or bankruptcy; a retail store foresees a large adverse judgment rendered against it by a former owner or employee. Each of these scenarios represents an instance in which a party might make a decision to transfer assets in order to avoid creditors or potential creditors. Before transferring any assets, however, one should be familiar with the substantial liabilities that one may incur if the transfer violates the Maine Fraudulent Transfer Act.

Maine Fraudulent Transfer Act

The Fraudulent Transfer Act (the "Act") was enacted in order to prevent transfers that are made for the purpose of hindering a creditor, or potential creditor, from collecting what is due, or what may become due, from a debtor. The purpose of the Act is to prevent the depletion of a debtor's assets to the detriment of unsecured creditors. The Act provides unsecured creditors with a means of relief in the event the debtor engages in transactions that are designed to conceal assets or place them beyond the reach of the unsecured creditors that are seeking to satisfy their claims.

Badges of Fraud

The Maine Law Court has held that: "Precisely because a transferor's stated reasons for transferring assets will rarely include an explicit of intent to defraud creditors, the statute provides a comprehensive, although not exclusive, list of factors to be examined when considering whether a transfer was made with the actual intent to hinder, delay, or defraud a creditor." *Morin v. Dubois*, 1998 ME 160, ¶5. When considering whether or not a particular conveyance is fraudulent within the meaning of the Act, the Court considers the following factors:

- A. the transfer or obligation was to an insider;
- B. the debtor retained possession or control of the property transferred after the transfer;
- C. the transfer or obligation was disclosed or concealed;
- D. before the transfer was made or obligation was incurred, the debtor sued or [was] threatened with suit;
- E. the transfer was of substantially all the debtor's assets;
- F. the debtor absconded;
- G. the debtor removed or concealed assets;
- H. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- I. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- J. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- K. the debtor transferred the essential assets of the business to a lienor who had transferred the assets to an insider to the debtor.

The factors above are referred to as "badges of fraud" and are considered by a court when determining whether or not a transfer was made in violation of the Act.

Scenario

If it is found that a party is in violation of the Act, the court may award damages in an amount that is double the value of the property transferred or concealed. By way of example: a small business discovers that he has serious health problems and will be incurring substantial debt within the next six months to a year. Aware that the debt collectors may eventually go after his business assets, which have been per-



By Patrick Mellor

sonally guaranteed, the business owner transfers the "family business," or a portion thereof, to his children, thereby protecting it from debts that he may accrue down the road.

If the businessman in our scenario did not receive consideration from his children that was reasonably equivalent to the value of the business, then it is likely that a court would find this transfer to be fraudulent, and the parties involved in the transfer would be subject to a judgment in an amount twice the value of the business that was originally transferred.

Fraudulent Intent Is Not Always Required

The Fraudulent Transfer Act provides an additional basis for avoiding certain transfers, whether or not there was an actual intent to hinder, delay or defraud creditors. If a debtor does not receive a reasonably equivalent value for the assets transferred and the debtor is engaging in a business or transaction for which his remaining assets are unreasonably small, the transaction may be avoided by a creditor. The test employed by the court is whether the debtor reasonably should have believed that he would be incurring excessive debts beyond his ability to pay future creditors. This "reasonable person" standard leaves a lot of room for interpretation, so it is prudent to err on the side of caution.

Transferring a Distressed Business Through a Leveraged Buyout

A leveraged buyout ("LBO") is a transaction that is often attacked by creditors during or after bankruptcy proceedings as fraudulent (See David

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their employment qualification as compared with younger workers. The prohibition against discrimination is designed to preclude just such a practice. Similarly, while failure to meet a production quota might, for example, provide a reasonable ground for discharge, the act would forbid the dismissal of such a deficient employee who would not have been discharged but for his numerical age.

In short, the proper inquiry is whether age was a substantial, even though perhaps not the only, factor motivating the employee's dismissal.

To some, it may be obvious that it would be unlawful to include the age of employees as a factor in deciding whom to terminate even when economic conditions demand layoffs. To others, however, an employee's age is simply a fact of life that a good business person has to and should be allowed to evaluate when making business decisions.

Although the employee alleging discrimination bears the burden to make out his case of age discrimination against his employer, including the 'but for' analysis described above, a claim can also be sustained in circumstances other than outright termination. Where an employee has been substantially demoted or his responsibilities severely restricted, courts have found for the employee under a theory of constructive termination. In other words, courts have found that an employer in practice, if not form, unlawfully terminates an employee when the employer materially and adversely alters the employee's working conditions by substantially downgrading his salary, benefits, power, and/or responsibilities. This also relates to transfers. A transfer could rise to level of discriminatory treatment if a court concludes that transfer resulted in working conditions that were so difficult or unpleasant that a reasonable person in transferee's place would have felt compelled to resign.

If an employer is charged with age discrimination and the

employee sufficiently alleges actual or constructive termination, the employer can still prevail by rebutting those allegations with legitimate, non-discriminatory reasons for the adverse action. Various court interpreting the federal statute upon which Maine's is based have found the following reasons sufficient to deny a charge of discrimination: (1) a reduction in sales territory; (2) excessive drinking by employees under terminated employee's supervision; (3) labor unrest under terminated employer's supervision; (4) nepotism and favoritism; (5) allegations of sexual harassment, (6) reduction in the mortgage market, and (7) a failure to participate in safety meetings.

What does this mean for the average employer. First, employers should conduct yearly reviews of all employees and keep records of the same. Any poor employee performance should be documented so that, if it escalates to a level where termination or demotion is contemplated, the employer does not have to scramble to substantively respond to a disgruntled employee's cry of "Foul!" Similarly, company handbooks, guidelines and policies should be purged of any and all references to mandatory or even recommended retirement ages. Remember, under the law, being forced out is no better than being told to leave. Finally, it is important that employers execute yearly employment contracts with any high-level employees. While a yearly contract opens the employer up to annual salary and benefits negotiations, it also insulates the employer from much more costly discrimination lawsuits. Contracts are usually unnecessary for all general employees because the risk analysis does not merit going to expense of drafting so many contracts.

In conclusion, while it is unlawful for an employer to take adverse action against an employee due to his age, it is not unlawful to terminate an unfit employee. Regular performance reviews, careful record-keeping, updated company guidelines and policies consistent with the law, and employment contracts are all ways to prevent litigation and keep your business running smoothly.

Perkins' Article on pg.1). If considering the sale or purchase of a distressed business through an LBO, both the buyer and seller should be sure that the price being paid for the assets can be supported by solid documentation of value. Additionally, in order to fend off potentially aggressive creditors, realistic and supportable projections of a company's ability to operate in the future should be made at the time of an LBO transaction.

Again, future creditors of a business can cause a transaction to be avoided,

or set aside, if the debtor did not receive adequate consideration and is left with unreasonably small capital with which to operate successfully, regardless of whether or not there was fraudulent intent

We can help

It is essential for a debtor, or a prospective debtor (whether that debt stems from health costs, business costs, or a court's judgment), to have carefully planned his course of action before transferring assets, especially if those assets are being transferred to friends

or family. Our firm provides services relating to debt restructure and bankruptcy that can aid in avoiding the substantial liability that accompanies a fraudulent transfer.

Additionally, a creditor should be aware that, in the event a debtor transfers an asset without receiving appropriate value, the creditor can ask the court to void the transfer, as well as seek double damages against the debtor. Our firm's expertise in these matters can be invaluable in ensuring that your interests are protected.

You are invited to a Breakfast Presentation on:

Buying and Selling Distressed Maine Businesses

The presentation will focus on risks and opportunities involved in buying troubled businesses, including strategies for (1) avoiding liens, claims and liabilities, (2) acquiring Maine businesses at modest prices in light of the need for a turnaround, and (3) financing options for acquiring distressed businesses.

**Wednesday, April 16, 2003, 7:30am
at Perkins Olson, PA
30 Milk Street, Portland, Maine
RSVP: Noelle Forrest at 871-7159
or email nforrest@perkinsolson.com**

We at Perkins Olson, P. A. want to provide you with high quality, reasonably priced legal services that will add value to your business. With this depth of talent we can help your firm prosper as well as resolve any difficulties that you may encounter.



Olson move quickly on questions involving a wide variety of business reorganizations and bankruptcies—from traditional manufacturing firms and real estate concerns to high tech companies. Patrick Mellor specializes in business law, civil litigation, maritime law,



and appellate work. He is a former University of Maine Law School writing instructor and a former law clerk. Kevan Rinehart deals in commercial, intellectual property, and land use issues and works on a wide range of bankruptcy and business reorganization issues.



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