A Guide to Buying Distressed Assets

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Many people are looking for companies, real estate, and assets that, for any number of reasons, are "distressed," which normally means priced at less than market value. However, how do you determine whether an asset is really a bargain versus a disguised headache? Further, how do you make this call quickly enough to take advantage of it? This guide is a quick reference to help you make these decisions. It provides the key questions to ask before purchasing a distressed asset and gives you the tools needed to answer those questions.

The Basics

What is a distressed asset?

Most people know that an asset is anything of value owned by a person or a business. When the person or business needs immediate cash and wants to sell the asset at less than its value, it becomes a distressed asset. Distressed assets fall into three basic categories: personal property, equity ownership in a business (which is a form of personal property), and real property.

Personal property includes physical equipment, accounts receivable, intellectual property and inventory, as well as equity ownership in a business or a business entity such as a corporation, limited liability company or a partnership. Personal property in the U.S. is largely governed by the Uniform Commercial Code, or "UCC", which nearly every state has adopted. The UCC makes the laws in most states fairly uniform when it comes to buying and selling assets. Business ownership (equity) is also governed by the UCC, as well as individual state and federal securities laws. Real property includes actual land or dirt, as well as fixtures and improvements made to the land. Fixtures are a grey area, so they can either be personal property or real property. Individual state laws govern real property, so it is important to know the laws of the state where the property is located before you buy or sell a distressed piece of real estate.

What are the pros and cons of buying distressed assets? – The D.O.V. Method

The primary attraction of buying a distressed asset is its value. In other words, the buyer thinks the value of the asset is greater than the asking price. The trick, though, is to determine if the value really is that much higher than the asking price or whether buying the asset will be more trouble and cost than it is worth. So how is that determination made? The answer comes in a method called the D.O.V. Method (pronounced "Dove"), which stands for

Debt, Ownership, and Value. The D.O.V. Method allows you to distinguish between hidden headaches and true gems before you buy them.

Debt Searching

Step 1 in the D.O.V. Method is Debt, meaning you must figure out what debt currently encumbers the asset. For instance, is there a bank loan or I.R.S. lien affecting the individual asset or is the company or person who owns the asset affected generally by an overriding debt or lien? If careful attention is not paid to this determination, the creditor that owns the debt might very well have superior rights to the asset.

Why do you have to verify debt?

The reason to verify the debt is to make sure the seller is telling the truth about the amount of the debt, and number of debts, affecting the property to be bought. You want to be sure that there are no other creditors lurking out there who can lay a claim to the property once you have acquired it. Keep in mind that the laws of many states allow a prior creditor to make claims against you if you purchase property with a prior lien affecting it. This is addressed further in the last section of this booklet.

What types of debts need to be examined?

There are three basic asset types, and each has its own type of debt. These asset types include real estate, equipment, and equity ownership in a business. The first debt category, real estate debt, is the easiest to search. For a creditor to secure a lien on real property, they usually must file a lien in the applicable real property records. Typically, a title company, or in some states an attorney, searches the debts and/or liens affecting real property, and you can search either by address, legal description, or by the owner of the property.

The second debt category, equipment debt, is almost as easy to search for as real estate debt. To have a secured lien against equipment, a creditor would file a UCC statement in either the office of the Secretary of State or the county records office where the equipment is located, or possibly both.

The third debt category, debt affecting equity in a company, is the hardest type of debt to search. Most creditors will file a UCC lien against a business or its owners when they claim a lien on equity interests, just like equipment. In that case, you can follow the same steps mentioned above regarding searching for debt on equipment. Additionally, there could be unsecured debt affecting the business that you are buying. Unlike real estate and equipment, which are normally only affected by debts specifically against those assets, a business can have a number of creditors who have never filed a searchable lien. For instance, a company could have a credit card with hundreds of thousands of dollars of debt unbeknownst to anyone except the business and that creditor. If that business is purchased, the buyer would own the business and could be subject to the paying back the debt.

Ownership

Step 2 in the D.O.V. Method is Ownership, meaning you need to verify that the party you are dealing with actually owns the asset. If they do not, it could mean that someone else really owns the asset and/or you could be participating in a scam to defraud the true owner from their asset.

How do I determine ownership of real property?

Real estate can be the easiest category to search for true ownership. Most property owners file their ownership of record in the county in which the property is located. Also, when acquiring real property, you nearly always engage a title company to insure a title, and title companies will not do that unless they perform their own search. One difficulty is when someone claims title outside of the chain of title, but that is exactly what title insurance companies are for, which is to reduce potential liability over such claims.

How do I determine ownership of equipment and other personal property?

Personal property ownership is almost as easy to search for as real estate. First, search for any liens secured by the personal property that you are buying. If the personal property is titled, like cars and other over-the-road vehicles or equipment, you can search the applicable motor vehicle or other similar governmental offices to ensure that the seller indeed owns the property. Having satisfied both of those criteria, the next place to check is the tax records. Nearly every state taxes personal property and you can also check to see who has paid the taxes on the equipment you are buying. Finally, if all of the above is satisfactory, the seller should provide a bill of sale and a representation that they own the equipment or the personal property in question. Many states have a common law feature that if the person buys the property for value and without notice, as these procedures should suffice for that qualification, this will often reduce claims from both the seller and third parties that could later claim ownership.

How do I determine ownership of a business entity?

To determine the ownership of a business entity, first search the lien and tax records just like you would for personal property. Then, a detailed analysis must be performed of the records of the entity. Next, you must determine the applicable secretary of state's office for all corporate filings made by the entity. Often, state taxes are forgotten or not filed which can cause the entity to forfeit its entity status. If that happens, the person who owns the entity becomes personally liable for its debts and liabilities. Finally, the seller must certify that the entity is in good standing, and they should represent the ownership of the entity to the buyer at closing. There are a variety of certifications and corporate documents that must be signed at the closing of the sale of such an entity to accomplish this correctly.

How do I know that the searches I made are sufficient?

Ultimately, reliance must be placed in the representations and indemnities given by the seller that he, she or it, in fact, own the asset in question. Those representations and indemnities are only as good as the value or net worth of the individual giving them. If that person has little or nothing of value after the transaction, such a representation or indemnity is worthless. That is why the word of the seller is never sufficient to warrant the purchase of a business without the additional searches mentioned above.

Value

Step 3 in the D.O.V. Method is Value, which involves determining the actual value of the asset you are buying. Steps 1 and 2 above will help determine if there are others out there that have better rights to the asset, but if the value of the asset is not what you thought or if there are underlying problems with the equipment, business, or real estate that you are buying, it will be better left unpurchased.

How is a distressed asset's value established?

The value of any asset equals what someone else will pay for it. It is much easier to value an asset if there is a market for it. In real estate, that market exists, and using comparable, recent sales, one can put a relative dollar figure on its value. However, real estate is inherently more or less valuable depending on its location. Real estate also has many environmental issues to be researched or has improvements and leases or entitlements affecting the property. Finally, the potential buyer should review the relevant city and state codes and restrictions to ensure that the proposed or even the current use of the property is allowable.

What about personal property?

Personal property also has a market, and there are a variety of ways to measure its value using comparisons found at used car and equipment companies and websites. One of the keys to valuing equipment is its depreciable life. The IRS has a variety of charts and rules when it comes to whether or not and how to depreciate the life of a piece of equipment. This is a hugely important factor when buying an asset because you may or may not be able to deduct depreciation of the asset from your tax liability.

How do I determine the value of the equity in a company when there is no market?

Private companies do not have an easily determined market, which brings us to an alternate form of valuation – the income stream method. Using the income generated or available from an asset, you can measure its value outside of a pre-existing market. Under the income stream method, you calculate the expected profit of the asset over its foreseeable lifespan and then discount that amount by the time value of money. This is also known as the net present value, because it measures not just the income of the asset, but by discounting it by the time value of money, it inherently measures the cost of holding this asset as inflation occurs over time. There are many other valuation methods, such as the internal rate of return, the price to earnings or P/E ratio, the liquidation method, discounted cash flow method and many others. Ultimately, your business broker and your accountant will help determine the value of the asset if there is no ready market by which to value it. Additionally, reviewing all of these methods together will often yield a solid dollar value of the worth of the asset.

Are these the only factors in valuing company equity?

Many businesses own both real estate and personal property, so the value determinations mentioned above must be applied to the overall value of the business. Second, there are also personnel issues, referred to sometimes as the human capital aspect of running a business. Most require a significant amount of human beings for their operation. So in addition to all of the other issues and even beyond the dollar value of keeping those employees, there are personnel issues to be addressed. Add to this that in most business purchases, the current owner normally wants to keep the sale as quiet as possible to avoid losing its employees, so employee interviews are often not possible prior to the purchase. This is potentially a big risk when valuing the business to be purchased.

Fraud and Bankruptcy Claims

Can third parties interfere with the sale or hold me liable?

The answer is potentially YES. Other creditors of the seller (and potentially even the seller itself) can interfere with a sale of a distressed asset, which exemplifies the need to be very careful in your due diligence when buying distressed assets. This applies to all types of assets discussed here, whether the asset is real property, personal property, or business equity. Fraud is a very common and serious charge that can be made when an asset is sold to the detriment of others who claim to own rights to the asset being sold and/or have unpaid claims against the Seller. The most applicable laws are the Uniform Fraudulent Transfer Act or the UFTA and Section 548 of the Bankruptcy Code. Most states across the U.S. have adopted the UFTA.

If a creditor of the seller asserts fraud claims under the UFTA and prevails, that creditor can seek to avoid the sale, seek an injunction, seek money damages, and seek equitable relief. Especially if the buyer of the asset knew about the claims, the buyer could be subject to these types of damage claims. Whether the buyer knows about the other creditors or not, the sale can still be voided and litigation can ensue over the sale.

The UFTA generally applies when the seller is insolvent or is rendered insolvent by the transfer. This means that the seller either cannot pay his debts as they become due or the seller's assets are worth less than his liabilities. Also, a transfer for less than a "reasonably equivalent value" may be avoided. Thus, if the asset really is "distressed," meaning it is being sold for less than its fair market value, then the UFTA could apply. There is a laundry list of other "badges of fraud" that bring in the UFTA. These include, among others, actual intent to hinder, delay, or defraud present or future creditors or a transfer made to an insider. An insider is someone, like a family member or the director or officer of a business entity, who controls or is closely affiliated with the seller or person filing bankruptcy.

Can the seller reverse the sale after the fact? What bankruptcy issues exist?

Again, the answer here is potentially YES. The seller could potentially reverse the sale by filing bankruptcy. Once bankruptcy is filed, the bankruptcy court could authorize the avoidance of a fraudulent conveyance made by the debtor/seller within two (2) years prior to the bankruptcy filing. If the person filing bankruptcy transferred an asset to a creditor to cancel (in whole or in part) debt owed to that creditor and did so to the detriment of other creditors, the transfer could be considered a "preference," and the transfer is therefore potentially subject to being reversed. The good news here is that a bankruptcy reversal is inapplicable unless the purchaser was also a creditor of the person filing bankruptcy.

How much time do I have to wait to ensure that the sale is final?

Claims under the UFTA in many states can be made for as long as four years after the transfer of the asset was made or for one year after the person making the claim discovers that the sale occurred. The "preference" period, meaning the timeframe in which the court can reverse a transaction due to a preference item, is 90 days for non-insiders and one year for insiders.

About the Author

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