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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION THREE

FORMATION INVESTMENT
HOLDING, LLC,

Plaintiff and Appellant,

v.

FORMATION ENTERPRISES, LP et al.,

Defendants and Respondents.

A126697, A127390

(San Mateo County
Super. Ct. No. 480546)

Formation Investment Holding, LLC (FIH) was a creditor holding a junior lien on the assets of Formation Enterprises, LP (Formation) when its lien was wiped out by a receiver's sale of Formation's assets. FIH appeals from an order confirming the receiver's sale, arguing it was unnecessary, unfair, and the result of collusion between the receiver and a creditor with a lien that was senior to Formation's. We conclude that FIH has not shown the trial court abused its discretion when it confirmed the sale, and affirm.

BACKGROUND

Formation was in the business of developing and importing custom housewares and gift items, primarily from China, for large retail chains. In 2007 it obtained a \$3 million line of credit from Bank of the West. (AA 236, 245)~ All the funds advanced by Bank of the West were secured by a first-priority security interest in Formation's assets and were personally guaranteed by two of Formation's executives.

In 2008 Formation obtained an additional \$1,200,000 in financing from FIH, also secured by liens on Formation's assets. FIH does not dispute that its security interest was subordinate to the Bank of the West lien.

Formation defaulted on its payments to both Bank of the West and FIH. Bank of the West sued to collect \$3,200,000 it was owed under its agreement with Formation, and subsequently reached a forbearance agreement with the company until mid-January 2009. On January 22, 2009, FIH sued Formation and moved for the appointment of a receiver. FIH specifically sought the appointment of Frank Morrow, whom it described as experienced and well-qualified. The court granted FIH's motion and appointed Mr. Morrow (hereinafter the receiver).

The receiver's initial report in March 2009 observed that Formation had \$3.6 million in assets and \$4.4 million in liabilities. He nonetheless believed the company could become successful and that its creditors' interests would best be served by allowing it to remain in operation. However, the receiver cautioned that this would require an infusion of new capital and the renegotiation or retirement of Formation's existing debt. He recommended that the pending litigation be held in abeyance and the company be given until April 30, 2009, to pursue potential lenders and investors and attempt to restructure its finances. He also recommended that Formation reduce its overhead by reorganizing its executive structure and cutting management compensation.

On April 2, the receiver told the court that Formation would be out of operating cash unless a capital infusion were made by the end of the month. The receiver believed the company would have to be liquidated in the absence of new funding.

On April 27, FC Crestone Formation, LLC (Crestone) acquired the Bank of the West debt and its first priority lien by written assignment. Two days later it asked the court to authorize the receiver to borrow \$500,000 from it for the benefit of Formation, to be secured by a lien on Formation's assets that would be senior to all existing liens. The receiver submitted a supporting declaration stating there was no other source of money

than the Crestone loan, and that without the loan he would be forced to immediately close Formation's business. Even though its approval would further subordinate its own lien, FIH stipulated to the proposal and the court approved the stipulated order.

The new funds were quickly exhausted. On May 5 Crestone moved for two court orders. One motion sought the court's approval for an additional loan of up to \$1,000,000 to sustain Formation's operations for another month and allow it to purchase inventory for the 2009 Christmas season.¹ This new loan was also to be secured by a first priority lien. The receiver again declared there was no other source of funding and that the only alternative would be to immediately close the business, which would substantially reduce the value of all creditors' collateral. If the loan were approved, the additional funds would likely enhance the interests of creditors by preserving the value of Formation's assets and increasing its inventory. The court granted the motion over FIH's opposition on May 11, 2009.

The other motion filed by Crestone requested the court to authorize and direct the sale of Formation's assets at an auction to be held on June 8. A supporting declaration from the receiver explained the necessity for the sale: "As detailed in my First Report . . . , Formation lacks sufficient working capital to continue as an ongoing concern and service its secured debt. As further detailed in my First Report, Formation would have been required to cease operations at the end of April, 2009 unless additional capital was made available to Formation immediately. The only source of such capital that became available is the short-term senior secured loans recently made (and proposed to be made) by Senior Secured Creditor. Although such short-term lending has allowed Formation to continue operations, absent a significant infusion of equity capital, Formation will not be able to continue operations with its current capital structure. I have determined that such

¹ Because Formation's business depended in large part on its Christmas season sales, it made large cash expenditures early in the year to order inventory for the holiday season.

an infusion of equity capital would be impossible for Formation to obtain since its assets are encumbered with such a significant amount of secured debt. Although my First Report, filed almost two months ago, also stated that Formation could not continue operations without a significant infusion of equity capital, neither Formation nor Junior Secured Creditor have been able to obtain or locate funds for such an infusion of equity capital. I have therefore concluded that the only appropriate resolution of Formation's present situation is the sale of substantially all of Formation's assets at a public auction in accordance with the procedures set forth in the proposed Order Authorizing and Directing Sale of Assets by Receiver." The receiver believed Formation's assets were worth less than its total secured debt, but that the assets would be significantly more valuable if sold together as a going concern than if the company were to be liquidated or foreclosed upon. The assets were to be sold "free of any liens, claims or interests."

FIH argued that the proposed auction was not commercially reasonable, that there was no clear legal basis for the sale, that it "may not be in good faith," and that there was no authority for selling the company's assets free and clear of FIH's junior lien. FIH asserted that the court should instead order Crestone to retain a broker or investment banker to actively market the company "and provide sufficient time prior to any auction for the marketing to be conducted."

The receiver believed the bulk sale of Formation's assets was the only practical alternative, and that whether the sale should be by means of an auction or a more conventional marketing program depended largely on whether Formation could obtain additional capital to fund operations during the time necessary to market the company. The receiver also noted that FIH stated it would file suit against him if Formation were promptly sold at auction. Accordingly, the receiver asked the court for instructions as to how the sale should be conducted. In light of FIH's threat of litigation, he requested permission to withdraw as receiver as an alternative to the court's instruction on the manner of sale.

The court authorized the receiver to sell Formation's assets, but declined to specify how the sale was to be conducted or grant the receiver permission to withdraw. On June 1, 2009, the receiver again applied to the trial court for instructions. Vigorous negotiations had failed to produce any consensus between Crestone and FIH regarding how Formation's assets should be sold. FIH had made "vague representations" that it would be willing to fund Formation's operating expenses to facilitate a longer marketing period, but, according to the receiver, failed to "make a practical proposal along those lines."

In support of the motion, the receiver submitted a detailed plan for the asset sale. The plan proposed retention of General Capital Partners, LLC (General Capital), to market the company, serve as sales agent and prepare and distribute due diligence materials, including a description of Formation's business and assets. General Capital would publish notice of the sale in local business newspapers and provide it to other national publications, organizations or individuals as General Capital deemed appropriate. FIH would also be authorized to publish the notice of sale in any publications of its choosing, and to distribute it to anyone or any organization. The asset sale was to be conducted by auction 30 days after General Capital was retained.

After FIH withdrew its opposition, the court entered the requested order on June 1, 2009. Thereafter, FIH pressured the receiver to postpone the sale. According to the receiver, FIH made vague assurances that it would consider loaning Formation additional operating funds provided its loans were given priority over Crestone's first priority liens. Crestone opposed any such arrangement, and the receiver considered FIH's demand for priority to be both impractical and unfair.

On June 26, the receiver applied for authority to borrow an additional \$824,000 from Crestone to keep Formation operating until the sale scheduled for early July. He explained that all of the previous loan proceeds were exhausted, the company's accounts

contained less than \$10,000, and its expenses until the date of the sale were expected to exceed \$824,000. The court authorized the additional loan.

General Capital was retained and prepared a “teaser,” or blind information summary, designed to help prospective investors assess their level of interest in the company without revealing proprietary information, including the company name. The teaser was distributed to approximately 1,000 potential buyers, including 800 that might pursue acquisition of a distressed company regardless of the type of business and 200 that might be specifically interested in a glass and ceramics importer like Formation. General Capital established a procedure to provide detailed financial information about Formation to potential bidders who executed a nondisclosure agreement and posted a refundable \$25,000 deposit as conditions of getting the confidential and sensitive information.

The sale was held on July 7, 2009. Crestone was the only bidder and made a credit bid in the amount of \$2.5 million. Crestone was declared the successful bidder, and FIH’s second-priority lien was wiped out as a result of the sale.

The receiver then applied to the court for confirmation of the sale. In support, he submitted a status report in which General Capital described its efforts to market Formation’s assets. Of the more than 1,000 entities General Capital identified and contacted in advance of the sale, very few had expressed interest. Only nine executed the nondisclosure agreement, and none of them bid at auction.

FIH opposed confirmation. It maintained that General Capital’s efforts to market the company were “a pretense” and the sale process “hopelessly flawed” because potential bidders were given inadequate information about Formation, inadequate time in which to assess the information, and the bids were due on July 3, a holiday. According to FIH, “it appears concerted efforts were taken during the supposed marketing process to ensure that Crestone would be the only bidder for the Company.” FIH supported its opposition with a declaration from Joseph Walsmith, a potential bidder who felt General Capital failed to provide sufficient information and time in which to investigate the

company and formulate an offer. FIH reiterated that if it was assured that any loan it made would have priority over Crestone's liens, it was willing to lend Formation additional operating funds.

The trial court confirmed the sale over FIH's objection. FIH appealed from the order confirming the sale and an ensuing judgment entered by stipulation. We ordered the two appeals consolidated.

DISCUSSION

I. *Legal Standards*

“ ‘Generally speaking if no good reason appears for refusing to confirm a receiver's sale, such as chilling of bids or other misconduct or gross inadequacy of price, the sale should be confirmed.’ ” (*People v. Riverside University* (1973) 35 Cal.App.3d 572, 582.) “Judicial confirmation of a receiver's sale rests upon the appointing court's sound discretion exercised in view of all the surrounding facts and circumstances and in the interest of fairness, justice and the rights of the respective parties. [Citation.] The proper exercise of discretion requires the court to consider all material facts and evidence and to apply legal principles essential to an informed, intelligent, and just decision. [Citation.] Our view of the facts must be in the light most favorable to the order and we must refrain from exercising our judgment retrospectively. Reversal is warranted only after concluding the trial court abused its discretion by confirming a fraudulent, unfair, or oppressive sale.” (*Cal-American Income Property Fund VII v. Brown Development Corp.* (1982) 138 Cal.App.3d 268, 274.) It is the appellant's burden to show an abuse of discretion. (*Blank v. Kirwan* (1985) 39 Cal.3d 311, 331.)

FIH cannot meet that burden. There was an ample basis for the court to determine that by July 2009 the auction sale proposed by the receiver had become necessary. (See *Cal-American Income Property Fund VII v. Brown Development Corp.*, *supra*, 138 Cal.App.3d at pp. 274-275 & fn. 7 [receiver must show necessity for both the sale and its timing].) Formation was in default on its financial obligations, and by March 2009 was

unable to survive without an infusion of capital and renegotiation or retirement of its debt. Crestone initially provided short-term financing, but despite those cash infusions Formation was unable to maintain the balance of funds it needed to continue operating. The receiver submitted evidence that there was no source other than Crestone for short-term funding, and that Formation's debt made it impossible for the company to obtain the capital it would need to restructure as a viable business. The court reasonably confirmed the asset sale on this record.

FIH argues the court's confirmation of the sale was an abuse of discretion because the record does not include proof that Crestone's liens were entitled to the same first priority status as the original lien assigned to it by Bank of the West. The contention is meritless. FIH admitted in its complaint and request for the appointment of a receiver that its lien was subordinate to the Bank of the West lien, and it never disputed in the trial court that Bank of the West had validly assigned its interest or rights to Crestone. Crestone adduced evidence of that assignment, and it sought and received leave from the court to make the subsequent loans to Formation on the express condition that the additional funds would be secured by its first priority lien.

FIH also faults the court's decision because "there is no indication whether the receiver knew (or even inquired) whether the personal guarantee of the [Bank of the West Formation principals] Mark Towery and Eric Miller continued in effect after the assignment from [Bank of the West] to Crestone." The argument appears to be that the receiver should have required Crestone to enforce the personal guarantees "before seeking further equity investments that diluted the interests of FIH." FIH cites no legal authority that requires a receiver to compel a creditor to enforce a guaranty before providing additional financing or pursuing foreclosure. There is no evidence here that the receiver did not investigate the potential for recompense through the personal guarantees, and no evidence that the guarantors who were principals of the failing business had the financial ability to make any significant repayment. FIH has, in any event, forfeited this

contention on appeal by failing to assert it in the trial court in opposition to the receiver's motions to authorize and confirm the asset sale.²

FIH's claim that the receiver never investigated the advisability of attempting a sale *before* obtaining short-term financing from Crestone is inaccurate. In his initial report the receiver observed that Formation might be able to succeed if it obtained new capital and restructured its debt, that its creditors' interests would be best served by giving it the opportunity to do so, and that the alternatives—foreclosure and liquidation—would result in Bank of the West receiving no more than \$0.50 to \$0.70 on the dollar, while FIH “*would be completely out of the money.*” (Italics added.) There is also ample evidence that the only way Formation was able to operate while it attempted to restructure was through the infusion of short-term financing. The trial court reasonably credited that evidence.

FIH also asserts that instead of proceeding with the auction, the receiver should have obtained the additional short-term financing offered by FIH to keep Formation going while continuing to market the company. The legal question, however, is whether the court abused its discretion by disagreeing and allowing the auction to proceed. It did not. In June 2009, with the prospect of Formation's demise in view, there were several communications between FIH and the receiver concerning the possibility of a loan from FIH. The receiver told FIH that to continue operating the company needed an investment of \$720,000. FIH suggested it would be willing to purchase Formation's accounts receivable for a percentage of the face amount, but the receiver declined because selling the accounts receivable would diminish the value of the company—and FIH acknowledged that the receiver's concern was “well taken. This is a bulk sale of the

² These points apply with equal force to FIH's complaints that the receiver “apparently” failed to enforce the downsizing of management he recommended in his first report, which is similarly unsupported by citation to law or evidence and is raised for the first time on appeal.

Company and we would not want to disturb that.” Alternatively, FIH said it was willing to lend to Formation, but only if its loan was given priority over Crestone’s liens. The receiver had previously rejected this proposal as impractical and unfair. Moreover, even at the eleventh hour FIH failed to provide the specific terms for such a loan that the receiver had been requesting for weeks. The receiver thus reasonably rejected FIH’s overtures and the court did not abuse its discretion in confirming Formation’s sale.

Finally, FIH contends the sale was “rigged” to “virtually guarantee[]” that Crestone would be the only serious bidder. It complains that the bids were due on July 3, a holiday, and that the “teaser” for the sale unfairly indicated that Formation was in financial difficulty. FIH also asserts that General Capital was unfamiliar with Formation’s business in general and with the geographical area and advertised the sale only in local business papers; that the breadth of data provided to prospective bidders was insufficient; and that prospective bidders were charged a \$25,000 deposit “but were not told that it was refundable.” To the limited extent these points have any factual support in the record,³ the court was not compelled to accept FIH’s thesis that as a result the sales process was “rigged” or unfair. The court has wide discretion in confirming a judicial sale, and FIH’s showing falls far short of the fraud, unfairness or oppression that would warrant our intervention in its exercise of that discretion.

³ For example, the latter proposition relies solely on Joseph Walsmith’s declaration that “I was never told, *although I did not ask*, that the \$25,000 deposit was refundable.” (Italics added.) FIH apparently did not object in the trial court that July 3 was a holiday, and adduced no proof that the date dissuaded any potential buyers from bidding. General Capital submitted documentation of its significant experience in the sale of distressed companies in numerous fields (including one housewares import-export business) and diverse geographical areas.

DISPOSITION

The order and judgment are affirmed. Crestone's motion to dismiss the appeal as moot is denied.

Siggins, J.

We concur:

McGuinness, P. J.

Pollak, J.