Non-Bankruptcy Alternatives to Chapter 11 Restructurings and Asset Sales

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A Practice Note providing an overview of various non-bankruptcy alternatives for liquidating, restructuring, or selling distressed assets. This Note discusses Article 9 foreclosures, receiverships, assignments for the benefit of creditors, and compositions as possible non-bankruptcy options for both companies and creditors.

Bankruptcy proceedings have become a common method for debtors and creditors to consensually, and non-consensually, resolve issues that arise when an enterprise does not have sufficient resources to satisfy its financial obligations. A bankruptcy case has the advantage of the Bankruptcy Code, a body of statutes that explicitly provide for debtor and creditor rights and obligations, as well as extensive case law interpreting the Bankruptcy Code.

To a debtor, a bankruptcy proceeding affords:

- Protection from separate legal proceedings that may dismantle its assets and bring its business and operations to a halt.
- An orderly process in which to shed assets and obligations and either liquidate under Chapter 7 or Chapter 11 or reorganize under Chapter 11.

To a creditor, a bankruptcy proceeding provides the transparency of court supervision, a clearly defined set of creditor rights and priorities, and a centralized forum for litigation. Both debtors and creditors benefit from the bankruptcy court's ability to bind hold-out creditors and from the comfort that comes from court approval of significant actions.

Despite the benefits, bankruptcy proceedings can be lengthy and complicated affairs. The disadvantages of a bankruptcy case include:

- The costs and fees of administering a bankruptcy case. Fees for the US Trustee, counsel, and professionals for the debtor, creditors' committee and, in some cases, equity committee or other special committees may be significant.
- The debtor must obtain bankruptcy court approval for actions out of the ordinary course of business and this can be a considerable drain on both management and operations.
- The outcome of a bankruptcy proceeding cannot always be certain as it takes place in an open, public forum where competing constituencies often vie for control.

Due to the high cost, long time frame, and uncertainty that a bankruptcy proceeding necessitates, professionals dealing with a financially distressed business often consider alternative schemes that, depending on the circumstances, can accomplish some of the same things that are effected in a bankruptcy proceeding, but in a simpler and more efficient manner. These alternatives include:

- **Uniform Commercial Code (UCC) foreclosure**. A state law remedy available to secured creditors, similar in some respects to a section 363 sale (see UCC Foreclosure).
- **Receivership.** A broad category of remedies, where a fiduciary is appointed by the court to take control over a business or asset and either operate or liquidate it for the benefit of creditors (see Receivership).
- **Assignments for benefit of creditors.** A state law proceeding similar to a Chapter 7 bankruptcy where a debtor's assets are assigned to a trust and then liquidated for the benefit of creditors (see Assignments for the Benefit of Creditors).
- **Compositions.** A contractual settlement between a debtor and its creditors that allows a business to restructure its debt obligations and continue as a going concern (see Compositions).

These four alternatives can provide a shorter, less complicated, and cheaper solution to a workout situation than a formal bankruptcy process and serve as options that restructuring professionals should consider before filing a bankruptcy proceeding.

This Note addresses each of these non-bankruptcy alternatives and provides an understanding regarding when they can be used. It also explains the various advantages and disadvantages of each alternative and how it compares to a bankruptcy proceeding.

UCC FORECLOSURE

WHAT IS UCC FORECLOSURE?

Article 9 of the UCC sets out a framework that permits a creditor to foreclose on its collateral efficiently while providing the debtor with various procedural protections. It is a simple and direct alternative to bankruptcy liquidation and allows a secured creditor to either sell or take possession of its collateral. Like the rest of the UCC, Article 9 is intended to create a uniform system across the country for creating and enforcing security interests. While Article 9 has been adopted by every state, some states have made minor modifications to the law or have adopted the most recent version of the law. Accordingly, it is important to consult local law whenever conducting a sale under Article 9.

A UCC foreclosure proceeding is a non-judicial proceeding commenced by the secured creditor when there is no dispute regarding the underlying obligation. It can be thought of as the contractual consequence to original, negotiated loan terms. If the creditor does not pay as promised, the lender can take or sell the collateral. Determining whether a UCC foreclosure is a secured creditor's best option depends on specific practical considerations that must be evaluated in each situation.

The benefits to a UCC foreclosure compared to a bankruptcy proceeding include that:

- It may be a faster alternative to realizing value for the secured creditor.
- It is generally more cost effective.

The disadvantages, however, include that:

- It is susceptible to being interrupted at any time by a bankruptcy filing.
- There is usually no court order approving the sale of the collateral or addressing any deficiency claim and, as a result, the sale may spawn later litigation with the borrower or any guarantors.
- It does not address the claims of unsecured creditors.
- The sale of the collateral may not yield the highest price.

For information on mezzanine loan foreclosures, see Practice Note, Mezzanine Loan Foreclosures (8-385-3969).

LIMITATIONS OF UCC FORECLOSURE

A foreclosure under the UCC is only available for personal property, including foreclosing on the equity of an operating business. The foreclosure for real estate is done under a separate system, outside of the UCC and is unique from state to state (see Practice Note, Foreclosure Auctions and Sales (NY) (w-002-7579)).

The UCC has several, specific statutory provisions addressing the disposition or possession of collateral by a secured creditor. This Note refers to sections of the UCC as enacted in the State of New York. However, analogous provisions have been adopted in almost every state. The basic statutory provision that governs UCC foreclosures is Article 9, section 610(a), providing that "after default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing" (UCC § 9-610(a)).

COMMERCIAL REASONABLENESS

Except in the case of a strict foreclosure where the creditor takes possession of the collateral directly and there is no sale (see Strict Foreclosure), the collateral is typically sold by the creditor to a third party. The disposition of the collateral must be "commercially reasonable". This is a crucial requirement explicitly provided in the UCC: "every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable" (UCC § 9-610(b)).

Failure to comply with the commercial reasonableness standard may result in judicial interference with the sale (UCC § 9-625(a)) or liability for damages (UCC § 9-625(b)). A lack of commercial reasonableness in the sale procedures also increases the risk of a fraudulent transfer action in a later bankruptcy proceeding (or similar state law proceeding) to set aside the sale. Because there is no court order at the time of a foreclosure sale to protect the foreclosing creditor or any purchaser, the professionals conducting the sale must ensure that the sale procedures appear objectively commercially reasonable.

The UCC explains that a disposition of collateral is made in a commercially reasonable manner if the disposition is made either:

- In the usual manner on any recognized market.
- At the price current in any recognized market at the time of the disposition.
- In conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

(UCC § 9-627(b).)

The UCC also recognizes that if a disposition has been approved by a judicial proceeding, a bona fide creditors' committee, a creditors' representative, or by an assignee for the benefit of creditors (see Assignments for the Benefit of Creditors), then it is considered commercially reasonable (UCC § 9-627(c)). However, this type of approval is not necessary to meet the commercial reasonableness standard (UCC § 9-627(d)).

While commercial reasonableness is generally a case by case concept, courts have found the following factors are indicators:

- Hiring an investment bank.
- Preparing an offering memo.
- Contacting potentially interested parties.
- Publishing notices of the sale in local and national newspapers and trade publications.

(See, for example, *In re Adobe Trucking, Inc.* 551 F. App'x 167 (5th Cir. 2014); *Vornado PS. L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296 (Del. Ch. 2002); *Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc.*, 68 A.3d 197 (Del. Ch. 2013); *SNCB Corp. Fin. Ltd. v. Schuster*, 877 F. Supp. 820 (S.D.N.Y. 1994), *aff'd,* 71 F.3d 406 (2d Cir. 1995).)

Due to the commercial reasonableness requirement and the possible uncertainty that follows a UCC sale without a court order, foreclosing creditors should pay close attention to:

- The nature of the collateral.
- The facts and circumstances of the sale transaction.
- Applicable case law.

In practice, if the selling creditor retains a professional to conduct the sale, the professional helps determine the appropriate manner for conducting a sale according to commercially reasonable methods.

PUBLIC VERSUS PRIVATE SALES

A foreclosing creditor has the option of whether it prefers to conduct:

- A public sale, in which the public is invited to participate.
- A private sale, which limits the potential buyers, provided that the sale is commercially reasonable.

If the foreclosing creditor wants to purchase the collateral itself, its rights are somewhat limited. It may purchase the collateral either:

- At a public sale.
- A private sale, but only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

(UCC § 9-610(c).)

Transferring title under a UCC foreclosure does not typically involve a bill of sale or other instrument, but may be evidenced by a transfer statement (UCC § 9-619(b)). The transfer statement may be prepared by the secured party and recorded in the appropriate filing office.

REALIZING VALUE IN A UCC SALE

The principal difference between a UCC sale and a bankruptcy sale is that the UCC sale does not have a court order providing that the assets are being sold free and clear of liens, claims, and encumbrances. However, the UCC allows a selling creditor to provide warranties or offer other indemnities to a buyer and also to disclaim warranties as appropriate. The UCC specifically provides for:

- **Warranties on disposition.** A contract for sale, lease, license, or other disposition may include the warranties relating to title, possession, quiet enjoyment, and the like which by operation of law accompany a voluntary disposition of property of the kind subject to the contract (UCC § 9-610(d)).
- **Disclaimer of warranties.** A secured party may disclaim or modify warranties (UCC § 9-610(d)):
  - in a manner that is effective to disclaim or modify the warranties in a voluntary disposition of property subject to the contract of disposition; or
  - by communicating to the purchaser a record evidencing the contract for disposition and including an express disclaimer or modification of the warranties.

  (UCC § 9-610(e).)
- **Record sufficient to disclaim warranties.** A record is sufficient to disclaim warranties (UCC § 9-610(e)) if it indicates that "there is no warranty relating to title, possession, quiet enjoyment, or the like in this disposition" or uses words of similar import (UCC § 9-610(f)).

Therefore, a UCC sale is "as is, where is." This means that unless the creditor chooses to make certain warranties, the seller is not making any warranties or representations about the collateral. There is also no court order protecting the buyer from later attack or liability, leaving the secured creditor to applicable successor liability law for its protection. As a result, the price realized in a foreclosure sale may be lower because the assets may be less attractive to a buyer.

NOTICE

A foreclosing creditor must provide proper notice before disposing of the collateral. The UCC is specific on both the parties that must receive notice and the minimum time period. The foreclosing creditor must send notice to:

- The debtor (UCC § 9-611(c)(1)).
- Any secondary obligor (UCC § 9-611(c)(2)).
- If the collateral is anything other than consumer goods:
  - any other person from which the secured party received, before the notification date, an authenticated notification of a claim of an interest in the collateral (UCC § 9-611(c)(3)(A));
  - any other secured party or lienholder that, ten days before the notification date, held a security interest or other lien on the collateral perfected by the filing of a financing statement that identified the collateral, was indexed under the debtor's name as of that date and was properly filed against the debtor (UCC § 9-611(c)(3)(B)); and
  - any other secured party that, ten days before the notification date, held a security interest in the collateral perfected by compliance with a statute, regulation, or treaty described in UCC Section 9-311(a) (UCC § 9-611(c)(3)(C)).

It is important for the foreclosing creditor to identify, as soon as practical, the parties that require notice because it may impact whether a foreclosure is a feasible option. To accomplish this, the foreclosing creditor should conduct a thorough lien and judgment search before sending the foreclosure notice. Recognizing that a creditor may want to conduct a lien search more than ten days before it sends notice, UCC Section 9-611(e) contains a safe harbor for the permitted time frame within which the foreclosing creditor may conduct a lien search and satisfy the notice requirement. The section provides that if a lien search is conducted no later than 20 days or earlier than 30 days before the notification date and the creditor notifies all secured parties or lienholders identified as of that time, the creditor satisfies UCC Section 9-611(c)(3)(B).

Notice to parties must be reasonably timely. UCC Section 9-612(a) states that reasonable timeliness is generally considered a question of fact and UCC Section 9-612(b) provides that ten days' notice before the earliest disposition described in the notice is considered reasonable. However, this ten day notice period only applies to the reasonableness of the notice of the sale. A foreclosing creditor must also ensure that the sale itself is conducted in a commercially reasonable time period and that there is adequate notice to potential buyers.

DEFICIENCY CLAIMS, SURPLUS, AND APPLICATION OF PROCEEDS

If the sale of collateral is not sufficient to cover the entire cost of the debt, the foreclosing creditor wants the right to pursue the debtor for the balance of the claim (an exception is a complete strict foreclosure where the entire claim is extinguished and no deficiency claim exists, see Strict Foreclosure). Anticipating this, the UCC specifies how the proceeds of the sale are to be allocated and how the parties address any deficiency or surplus. UCC Section 9-615(d) generally provides for the debtor to receive any surplus or to be liable for any remaining deficiency.

The UCC also provides for special treatment to determine the amount of any deficiency or surplus when the foreclosing creditor or a person related to the creditor purchases the collateral at its own foreclosure. In this situation, a foreclosing creditor may lack the incentive to maximize the proceeds of a disposition. UCC Section 9-615(f) provides that the deficiency must be calculated as if the disposition was to an unrelated party (see Practice Note, Mezzanine Loan Foreclosures: Mezzanine Lender as Purchaser of Collateral (8-385-3969)).

To ensure that a creditor does not have to go out of pocket to foreclose on its collateral, UCC Section 9-615(a) provides the secured party with the right to be reimbursed from sale proceeds for the reasonable expenses of the foreclosure sale as well as reasonable attorney's fees and legal expenses.

STRICT FORECLOSURE

On occasions when the debtor and the creditor can agree, the secured party can take possession of the collateral without a sale. This is known as "strict foreclosure" and it is governed primarily by UCC Sections 9-620 and 9-621. A "partial strict foreclosure" occurs when the secured party has a deficiency claim after taking possession of the collateral, and a "complete strict foreclosure" occurs when there is no deficiency claim and the debt is fully discharged.

Because a strict foreclosure does not have a public sale process or other method for valuing the collateral and protecting the debtor, the debtor must cooperate. A creditor may accept collateral in full or partial satisfaction of the obligation it secures if both:

- The debtor consents to the acceptance.
- The secured party does not receive a notification of objection from any party entitled to give one.

(UCC § 9-620.)

A debtor is deemed to have consented to acceptance of the secured party's retention of the collateral in full satisfaction of the outstanding debt if the debtor does not object to the secured party's proposal within 20 days after the proposal is sent to the debtor (UCC § 9-620(c)(2)). In contrast, where a secured party seeks partial satisfaction of a debt, the debtor must affirmatively consent in an authenticated record (UCC § 9-620(c)(1)) and any secondary obligor must also receive notice (UCC § 9-621(b)).

Because it is a collaborative method of enforcement, a strict foreclosure generally involves lower transactional costs and is less likely to result in litigation (see Practice Note, Mezzanine Loan Foreclosures: Strict Foreclosure (8-385-3969)).

RECEIVERSHIP

WHAT IS A RECEIVERSHIP?

A receivership is a general term that describes the circumstance where a third party is appointed to administer assets that are the subject of a dispute or a claim. The third party is referred to as a "receiver" and the administration of the assets is referred to as a "receivership". Receivers may be appointed by a court order, regulatory department action, or private agreement and their powers vary as a custodian of the company's property, including its funds. Receivers should only be appointed when the entity is insolvent and there is a concern that the assets are likely to be misappropriated or wasted.

Receiverships are typically initiated after an entity fails to pay its debts as they come due or fails to meet its legal obligations. Receivers are often appointed to liquidate or wind up the affairs of an entity, but the appointment of the receiver does not cause a dissolution of the company. A receiver may also be appointed to continue to operate a business as a going concern.

TYPES OF RECEIVERSHIPS

There are numerous types of receiverships, however the most common are commercial receivership actions brought by a creditor in federal or state court and granted under a court's equitable powers or statute. In these cases, the court's order defines and limits the receiver's power. There is often no defined test for the appointment of a receiver and, depending on the state, the court refers to either:

- The facts and circumstances of the situation to determine whether a receivership appointment is equitable.
- The statute to provide guidance.

Federal Receivership

To determine whether a receiver should be appointed, federal courts use a test similar to what is used in preliminary injunction inquiries. The test requires weighing the following factors:

- The existence of a valid claim by the creditor.
- Fraudulent conduct on the part of the defendant.
- Imminent danger that property is likely to be lost, concealed, injured, diminished in value, or squandered.
- Inadequacy of other remedies.
- Balance of harms.
- Creditor's probable success in the underlying action.
- Possibility of irreparable injury to the creditor's interest in the property.

If a secured party is properly pursuing its claim in federal court, the court has ancillary jurisdiction to appoint a receiver. A district court may appoint a receiver, even for property located outside its geographical jurisdiction, although the district court must find that there are minimum contacts to exercise jurisdiction over the defendant. Once appointed by the federal court, the receiver becomes an officer of the court obligated to manage and operate the property according to the laws of the state where the property is located. The petitioning creditor may also request a particular person or entity to act as receiver.

While a stay of pending actions against the entities in receivership is not automatic, as courts of equity the federal court has broad authority, in appropriate circumstances, to impose a stay. If a party wishes to commence an action against the debtor in a different forum, the party must seek permission from the receivership court. Receivership law has no inherent limitation regarding the amount of control that a receiver may wield over the receivership entity.

State Court Receivership

Courts in most states have the authority to appoint receivers, either by specific statute or under their general equitable authority. State court receivers may be granted the power to operate the debtor's business although it is more common to empower receivers to liquidate the assets and distribute the proceeds. The court or the relevant governing statute prescribes the procedures for filing claims and sharing in the distribution. The priority of claims are determined by applicable state law, which generally means that the first-lien creditor has the right to first proceeds after the receivers costs of administration.

Delaware corporate law has a relatively detailed statutory scheme for the appointment of a receiver in the case of insolvency (see Del. Code Ann. tit. 8, § 291).

State Law Insolvency Receivership: Delaware

In the case of a Delaware corporate obligor, a Delaware insolvency receivership may be attractive because of the relatively detailed insolvency receivership statute and the familiarity of the Delaware Court of Chancery in dealing with corporate matters. The Delaware Court of Chancery also has detailed rules applicable to the receiver and receivership (see Del. Ch. Ct. R. 148 to R. 168).

Under Delaware law, any creditor or shareholder may request the appointment of a receiver of an insolvent corporation (Del. Code Ann. tit. 8, § 291). The powers of a Delaware insolvency receiver are broad. However, the statute is permissive and the appointment of a receiver is generally only granted where it serves some beneficial purpose not achieved by ordinary debt collection procedures (such as the failure to administer the enterprise, concern regarding dissipation of assets, and so on). Because a Delaware receivership is flexible and the Chancery Court Rules are explicitly permissive and subject to relief, it may be a significantly faster and less expensive alternative to a formal bankruptcy proceeding.

GENERAL RESPONSIBILITIES OF A RECEIVER

A receiver is a disinterested person appointed to collect and protect property that is the subject of various claims. The receiver is an officer of the appointing court and a fiduciary to all creditors of the entity. A receiver has those powers conferred by statute, if any, including those:

- Reasonable or necessarily implied from the statute.
- Expressly conferred by the court's appointment order.
- Reasonably or necessarily implied from the court's order.

A receiver is typically tasked with:

- Identifying the assets and liabilities of the entity.
- Taking possession of assets and property.
- Marshaling assets.
- Serving as management of a debtor's business.

An order appointing the receiver generally requires the receiver to issue regular reports regarding the status of the assets. For example, the Delaware insolvency receivership statute provides that "trustees or receivers shall, as soon as convenient, file in the office of the Register in Chancery of the county in which the proceeding is pending, a full and complete itemized inventory of all the assets of the corporation which shall show their nature and probable value, and an account of all debts due from and to it, as nearly as the same can be ascertained…" (Del. Code Ann. tit. 8, § 294).

Receivers typically must post a bond, usually based on the amount in controversy and the value of the assets of the obligor. The bond comes from their own funds and is intended to protect the parties from gross mismanagement or fraudulent activity by the receiver.

Like a Chapter 7 trustee, a receiver is generally compensated from the property in the receivership. Compensation structures vary and may be based on an hourly rate, a flat monthly fee, or a percentage of funds managed or distributed. A receiver is often given discretion to retain and compensate employees and professionals from estate assets to assist in the receiver's duties. Creditors seeking the appointment of a receiver work with the receiver to ensure that cash is available to cover the receiver's fees, often in the form of providing a carve-out from the creditor' lien or by providing an indemnity.

KEY ATTRIBUTES OF A RECEIVERSHIP

While the statutory schemes for receiverships are not nearly as comprehensive as the Bankruptcy Code, several aspects of a receivership are analogous to a bankruptcy proceeding:

- A receivership is an attempt to consolidate control over all defendants and their assets, including affiliated entities, in a single proceeding and under common control.
- The court appointing a receiver may enjoin actions against the receivership estate to assist in the efficient administration of the receivership estate, similar to an automatic stay under section 362 of the Bankruptcy Code. The injunction, however, is not automatic, as it is under the Bankruptcy Code, nor is it necessarily as far reaching in its jurisdiction.
- The receiver is empowered to sell or otherwise dispose of assets.
- Similar to sales under section 363 of the Bankruptcy Code, both public sales and private sales are authorized in federal receiverships. However, special provisions, including the requirement for appraisals and special restrictions on private sale, apply to the sale of real property in a federal receivership (28 U.S.C. § 2001) and may be extended to sales of personal property (28 U.S.C. § 2004). State receiverships can have their own statutory provisions regarding asset sales.
- A receiver can bring certain avoidance actions for fraudulent transactions.

ASSIGNMENTS FOR THE BENEFIT OF CREDITORS

WHAT IS AN ASSIGNMENT FOR BENEFIT OF CREDITORS?

An assignment for the benefit of creditors, commonly known as an ABC, is a state law insolvency proceeding implemented by assigning the debtor's assets to an assignee acting like a trustee over those assets. The assignee then liquidates the assets for the benefit of the creditors. A debtor subject to an ABC does not continue to operate its business or reorganize and does not receive a discharge of its debts.

ABCs are generally implemented under a statutory scheme. Many states have comprehensive ABC statutes in place, including:

- New York (see N.Y. Debt. & Cred. Law §§ 1-24; N.Y. Lab. Law § 574).
- New Jersey (see N.J. Stat. Ann §§ 2A:19-1 to 2A:19-50, 2A:20-1 to 2A:20-11, 3B:15-8, 54A:8-6, 54:4-106, and 22A:2-35).
- California (see Cal. Code Civ. Proc. §§ 493.010 to 493.060; Cal. Code Civ. Proc. § 1800-1).
- Texas (see Tex. Bus. & Comm. Code Ann. §§ 23.01 to 23.33).

Others, such as Delaware (see Del. Code Ann. tit. 10 §§ 7381 to 7387), have specific ABC related statutory provisions even if there is no comprehensive statute. A few states, such as Illinois, have no specific ABC statute and an ABC relies exclusively on common law principles.

WHAT TYPE OF DEBTORS CAN MAKE AN ABC?

While any type of entity can do an ABC, an ABC is not typically suitable for individual obligors because an ABC does not provide a debtor with a discharge of its debts and the debtor may still be subject to claims.

Companies should be aware that because an ABC involves the transfer of all or substantially all of the entities assets to the assignee, shareholder consent is often required under applicable state law. This means that a board vote alone cannot approve the filing of an ABC. Shareholder consent may be difficult to obtain, particularly when there is a large, diverse group of shareholders.

Also, an ABC is typically an event of default under most loan agreements and many other contracts, so a debtor considering making an ABC should be careful to negotiate with relevant counterparties in advance.

THE ASSIGNEE

The assignee is usually selected by the debtor but is a fiduciary to all creditors and is typically an accountant or other professional with experience in liquidating assets. If there is a surplus of funds, the assignee may then become accountable to the debtor. Therefore, it is advisable for the assignee to be a disinterested third party, independent of the debtor's management.

The assignee often must post a bond and make regular reports to the supervising court. The assignee's mandate is to maximize the value of the estate available for creditors by selling off assets timely and in an orderly fashion.

The assignee is generally compensated from unencumbered proceeds of the estate. It is common for assignees to require an advance retainer to consent to the assignment and may attempt to negotiate a carve-out or other assurance of payment from the secured creditor.

The assignee typically takes the assets from the debtor under a formal assignment agreement. In some states, that is followed by notice to the court or registry (see Del. Code Ann. Tit. 10 § 7381). In other states, such as California, notice is given to the creditors but no court filing is made (Cal. Code Civ. Proc. § 1802).

ORDER OF PRIORITY

The assets assigned under an ABC remain subject to all existing liens and encumbrances. As a result, secured creditors have a priority regarding any proceeds from their collateral and any assignment is likely to require their consent to function effectively. The general order of priority of claims varies from state to state, but federal tax claims are generally paid first. Several states, such as California (Cal. Code Civ. Proc. § 1204) and New York (N.Y. Debt. & Cred. Law § 22), also have detailed priorities for various wage and benefit claims.

For more information on priority schemes in ABCs, see Practice Note, Assignments for the Benefit of Creditors: Distribution of Funds: Priority of Claims (w-006-7771)

STATE LAW ON ABCs

In jurisdictions that have adopted section 9-309 of the UCC, the assignee has the status of a perfected lien creditor, although some states also require recordation (N.H. Rev. Stat. Ann 569:1).

The assignee under an ABC has the ability under the Uniform Fraudulent Transfer Law to avoid fraudulent transfers made by the assignor before filing the ABC. Also, some states have adopted statutes that mirror the preference provisions of section 547 of the Bankruptcy Code. As a result, creditors receiving payments before an ABC assignment can expect the assignee, in those states that have enacted preference-like statutes, to review those transfers.

For more information on avoidances in ABCs, see Practice Note, Assignments for the Benefit of Creditors: Asset Recovery: Avoidance Powers (w-006-7771).

STATE JURISDICTION AND CONFLICTS OF LAW

The validity of an ABC is generally determined by the courts and law of the jurisdiction in which the assignment is made (see NY Debt. & Cred. § 2). However, some jurisdictions require that the assignment is registered where the property is located (see Del. Code Ann. Tit. 10 § 7381). It is crucial that the state court in which the ABC is proceeding must have jurisdiction over the assignor, which enables the assignee to exercise authority concerning the property.

ABCs VERSUS THE BANKRUPTCY CODE

Because it is a streamlined, limited purpose procedure intended primarily to liquidate assets, an ABC is typically much faster than a bankruptcy proceeding and less expensive. However, there are disadvantages of choosing an ABC rather than a bankruptcy case, including:

- An ABC does not provided for a discharge of an assignor's obligations and only transfers assets to a trust.
- An ABC cannot affect any of an assignee's contractual obligations and cannot be used to assign leases or other executory contracts without the counterparty's consent.
- ABCs do not have a cap on a landlord's long-term non-residential real property lease claims and these claims may be large and reduce the recovery available for other creditors.
- In many states, an ABC does not give rise to an automatic stay, leaving the debtor open to any judgments from lawsuits pending at the time of the ABC.
- While ABCs are used most frequently in California, other jurisdictions have less familiarity with the procedure. As a result, court clerks and other judicial staff may be unfamiliar with the documents involved and the procedures for docketing those documents. Filing properly may require extensive coordination with the clerk's offices. The judges themselves may also not be familiar with ABCs or the process involved in an ABC proceeding.
- A debtor subject to an ABC can still be placed into an involuntary Chapter 7 proceeding. While it is possible that the bankruptcy court may exercise its right to abstention and force the creditors to continue with the state proceeding, it is also possible that the debtor may still remain in the involuntary Chapter 7 and lose the benefits expected from the ABC.

For more information on ABCs, see Practice Note, Assignments for the Benefit of Creditors (w-006-7771).

COMPOSITIONS

WHAT IS A COMPOSITION?

A composition is a non-statutory, out-of-court arrangement in which a debtor enters into a contractual relationship with two or more of its creditors agreeing to accept partial payment on their debt.

Compositions are a long standing commercial concept that came before and have generally been superseded by the development of the Bankruptcy Code and state insolvency proceedings. However, they can still be useful in specific circumstances, particularly where the goal is to rehabilitate a struggling business as opposed to liquidate.

TYPES OF DEBTOR USING COMPOSITIONS

Because a composition is contractual and voluntary on the part of creditors, it can be used for almost any form of organization. Compositions are most useful when:

- The debtor has a relatively limited and known set of creditors with an interest in the debtor's ongoing survival.
- There is good relationship and high degree of trust between the debtor and the creditors and among the creditors.
- Individual creditors have not advanced any collection efforts that give the creditor a substantial advantage over other creditors.

For these reasons, it is often helpful if a committee of creditors is formed with several creditors serving as representatives.

Compositions may be difficult when creditors have little stake in the ongoing business prospects of the obligor, such as secondary market claims buyers. Therefore, a debtor considering a composition must begin the process early before collection efforts advance too far and debt changes hands.

Because the composition agreement cannot bind creditors not signing on to it, the composition must be agreed to by a high threshold of creditor support, either in number or dollar amount. Those creditors that do not participate continue to retain full claims, creating financial risk for both the debtor and the consenting creditors.

THE COMPOSITION AGREEMENT

The centerpiece of a composition transaction is the composition agreement, which is negotiated between the debtor and the consenting creditors. The hallmark of a composition agreement is its flexibility. The structure of each agreement varies. One type of composition may provide that creditors are paid in full, but the maturity is extended and paid in installments if certain milestones are met. Another type may require that creditors reduce their claims, while another composition agreement may allow creditors to cash out their claims by selling them to a backstop investor. Any combination of these is possible.

A relatively simple composition agreement may contain some or all of the following provisions:

- An acknowledgement of the claims of the consenting creditors and a representation regarding the amount of all other claims.
- An extension on the due dates of payments or the creation of a specific payment schedule.
- A minimum acceptance threshold for the percentage of creditors or claims signing the agreement as a condition to effectiveness.
- An initial cash payment by the debtor and an escrow agent to receive and distribute future payments.
- A provision for dealing with disputed claims or claim amounts with a reserve for distributions until the disputes are resolved (the provision may provide for mandatory mediation or arbitration).
- A "standstill" whereby creditors agree not to pursue their claims, including filing any collection actions or a bankruptcy proceeding so long as the debtor is performing under the composition agreement.
- Covenants relating to the operation of the business, including restrictions on non-ordinary asset sales or acquisitions, incurrence of debt, financial reporting, and so on.
- Default provisions that include the right of creditors to have their full claim reinstated in the case of certain specified defaults.

If a creditor representative or committee has been formed, then that entity, together with the debtor, can help solicit consents to the composition and explain to creditors the benefits of pursuing a consensual composition rather than a bankruptcy proceeding, including:

- Avoiding the debtor.
- Continuation of the business.
- Potentially higher recoveries to creditors.

In the right circumstances, a composition can be significantly faster and far less expensive than even a pre-packaged bankruptcy. Moreover, because a composition is an entirely private affair, the risk of business disruption is much lower from adverse publicity and market speculation can be much lower. A composition does not work, however, when the creditor body is diverse and has no stake in the debtor's reorganization or when a significant number of creditors cannot be relied on to voluntarily agree to a restructuring plan.