

**ASSIGNMENT FOR THE BENEFIT OF CREDITORS, STATE COURT
RECEIVERSHIPS, AND BANKRUPTCY OPTIONS**

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I. CORPORATE OPTIONS WHEN IN FINANCIAL DISTRESS

A. INTRODUCTION

Corporations confronting financial distress have several options available to them in attempting to work out their debt or manage their assets. In these materials, I address several options, including assignment for the benefit of creditors, receiverships, chapter 11 liquidations, and chapter 7 liquidations. Each option has advantages and disadvantages. An attorney well versed in this practice area must be aware of these advantages and disadvantages in order to design a custom approach on behalf of a company seeking to chart the waters of financial distress.

B. ASSIGNMENT FOR BENEFIT OF CREDITORS

The Assignment for the Benefit of Creditors (“ABC”) is a transfer of legal and equitable title to all of the debtor’s property to a trustee (an “assignee”) with authority to liquidate the debtor’s affairs and distribute proceeds equitably to creditors.¹ Functionally, an ABC appears to look similar to a chapter 7 bankruptcy case governed, however, by state, as opposed to federal, law, wherein the debtor generally assigns all of its property to an assignee for the benefit of its creditors. The consequence of the ABC is to place the property out of the reach of the debtor’s creditors by direct enforcement action.

¹ The Law Governing Liquidation, Garrard Glenn, Baker Voorhis (1935).

C. RECEIVERSHIPS

The state court receivership is governed by state law and generally requires the commencement of a civil action. Pursuant to the civil action, a state trial court orders the appointment of a receiver to take control of all the property of the defendant (debtor). The property is then considered *in custodio legis*. Thus, the property is no longer subject to direct enforcement action by the creditors.

D. CHAPTER 7 CASE

A bankruptcy case under chapter 7 of the Bankruptcy Code is a liquidation. Often, you hear lawyers refer to chapter 7 cases as "straight" bankruptcies. Generally, all of the debtor's assets are collected by the chapter 7 trustee (who is always appointed by the U.S. Trustee) who identifies, collects, liquidates, and distributes them. The proceeds from assets are distributed to the various creditors who have filed a proof of claim before the deadline known as the bar date.² The case is closed once the estate is fully administered.

For the creditors, the ultimate goal of a chapter 7 case is the efficient collection, liquidation, and distribution of estate property in satisfaction of allowed claims. The

² See 11 U.S.C. § 726 (2006).

distribution of estate property to satisfy allowed secured and unsecured claims is made in accordance with the distributional scheme embodied in the Bankruptcy Code. Thus, the chapter 7 case is in the nature of an accounting of the debtor's property to its creditors.

E. CHAPTER 11 LIQUIDATING CASE

A bankruptcy case under chapter 11 may be in the form of either a rehabilitation of the debtor or an orderly liquidation. Through the commencement of a chapter 11 case, a debtor attempts to reorganize itself either through rehabilitate or orderly liquidation. Generally, the debtor keeps all of its assets and remains in business.³ Here, the debtor remains in control of the bankruptcy estate. The debtor may continue to engage in ordinary course transactions without court supervision; however, court approval through an order is necessary to authorize transactions outside of the ordinary course of business.⁴ A trustee may be appointed to operate the debtor's business;⁵ however, the typical situation is one in which the debtor itself operates the business as a debtor-in-possession.

In a chapter 11 case, the debtor proposes a plan of reorganization in which it attempts to provide a satisfactory schedule of payments and possibly collateral to its creditors. After approval of the disclosure statement, the debtor solicits affirmative votes from its creditors and equity holders in favor of its proposed plan of reorganization.

³ See 11 U.S.C. §§ 1107, 1108 (2006).

⁴ See 11 U.S.C. § 363(c)(1) (2006).

⁵ See 11 U.S.C. § 1104 (2006).

Ultimately, the debtor hopes the plan is confirmed by the court.⁶ Plan confirmation may take two paths: (1) by unanimous consent or (2) by cram down so long as one non-insider impaired class of claim has accepted the plan. This plan may legitimately call for the orderly liquidation of the debtor's property, although, it is now more common to sell assets pursuant to section 363 of the Bankruptcy Code and follow that sale with a liquidating plan that often employs the use of a liquidating trust.

II. ABC

A. INTRODUCTION

The ABC is a creature of state law. Thus, one must confront a mix of state laws to determine the scope, rights, and obligations associated with the use of ABC. These statutes are designed to effectuate the intent of ABCs, that is, the authority on the part of the debtor to make a general assignment of its assets to an assignee for the benefit of its creditors.⁷

⁶ See 11 U.S.C. § 1129 (2006).

⁷ For an excellent source on ABCs, see Geoffrey L. Berman, *General Assignments for the Benefit of Creditors* (American Bankruptcy Institute 2006).

B. PROCEDURE

The ABC is initiated by the issuance of a deed of assignment executed by the debtor/assignor to a named assignee/trustee. The deed transfers all of the debtor's assets to an assignee. Partial assignments are not authorized. Typically, the deed of assignment will include a list or inventory of assets transferred and a list of all creditors and their respective claims.

C. ASSIGNEE POWER AND DUTIES

Upon the assignment and acceptance of the general assignment of assets, the assignee is required to provide public notice of the assignment to all listed creditors. As of the assignment, title to all property transferred vests in the assignee. The assignee has the power to transfer such assets, to sue on behalf of the estate, to collect accounts, and to settle and compromise all claims and disputes. In some jurisdictions, sales of property must be confirmed by a court.

The assignee generally has the authority to employ legal counsel and other relevant professional persons. In certain limited situations, usually with court approval, an assignee may also seek to operate the business for a limited time.

As a representative of the creditors, the assignee must act in their best interests and is subject to the panoply of fiduciary duties that regularly exist in this field.

Furthermore, as the creditor's representative, an assignee may seek to enforce state fraudulent transfer law to rescind pre-assignment transfers as either actual or constructively fraudulent and, in some jurisdictions, seek to recover preferences, although the later power is controversial and far from settled.

Generally, an assignee must file a final accounting to close the case. At that time, an assignee will begin distributions to the creditors. Moreover, an assignee may seek permission to pay its professionals. An assignee is typically paid a commission based on a percentage of assets administered.

State law provides the distributional scheme in an ABC. First, secured creditors receive a return of their collateral or the value of their collateral. Second, administrative expenses are generally paid, including the expenses incurred in administering the estate. Third, various priority claims are paid, including taxes, wages, and other jurisdiction-specific claims. Finally, general unsecured claims are paid to the extent any proceeds from the monetization of assets remain.

D. ADVANTAGES

The ABC provides many benefits. Among these are the following:

- Far less costly procedure than bankruptcy
- Greater flexibility than bankruptcy

- Expedited procedure
- Power to conduct investigations, examine, and depose witnesses
- Limited power to operate the business post-assignment

E. DISADVANTAGES

The ABC does present several limitations and disadvantages, especially when compared to a bankruptcy law alternative. These include the following:

- Assignee may not sell property free and clear of liens
- Preference power does not exist in most states and is controversial in those states that do recognize it
- No recognition of equitable subordination
- Limited territorial jurisdiction
- No discharge
- Limited or no immunity to assignee

III. RECEIVERSHIPS

A. INTRODUCTION

The federal or state court receivership is an ancient remedy. Receiverships can be created based on the authority of many federal and state laws. Moreover, the general concept of an “equity receiver,” *i.e.*, a party with full authority to operate the company during litigation, is an equitable remedy that exists in federal (and many states’) common law, without the existence of a specific authorizing statute. As a result of this multiplicity of authority, both the blessing and the bane of receiverships is that they possess great flexibility. In large measure, they operate based solely on the authority granted by the court order that authorizes the receiver. Thus, it is critical to ensure that such an order is sufficiently broad and comprehensive to ensure that the receiver is granted the powers necessary to fully control the entity’s assets and litigation. Such an order can, for instance, impose a stay on litigation that parallels the scope of the automatic stay in bankruptcy.

B. PROCESS

Essentially, a receiver is an individual or entity appointed by the court with such powers as the court deems appropriate to take control of property of the defendant, usually to identify, marshal and preserve the property, manage it, and frequently liquidate

the property. Thus, a receiver can be appointed to take over the operation of a legitimate business that was being used to perpetrate a fraud or to locate assets stolen from the victims of a Ponzi scheme.

The receivership generally is commenced with the secured lender filing a complaint with the applicable state or federal court as the plaintiff, setting forth the reason for the receivership, what it hopes to accomplish in the receivership, who it would like to have appointed as receiver, and how the receivership will operate mechanically. The receiver is appointed by and periodically reports to the judge and carries out the plan, most likely the disposition of assets.

If the disposition has not previously been approved, once the proceeds from the sale of assets have been collected, the receiver seeks the judge's approval for the distribution. The receivership is then wound down.

C. ADVANTAGES

The receivership possesses many advantages, including the following:

- Receivers have essentially the same authority as bankruptcy trustees to bring actions to avoid fraudulent transfers

- Receivers have tended to fare better than bankruptcy trustees in avoiding application of the *in pari delicto* defense when suing on behalf of the corporation.
- Receivers may enjoy immunity for actions within the scope of the receivership
- Authority is flexible and may be tailored to the needs of the actual civil action
- Receivership property is protected while in custodia legis
- Receiver may displace incompetent or fraudulent management
- Receiver may operate the business with greater flexibility
- Receivership generally results in lower professional and administrative costs and therefore a higher amount of proceeds to be paid to the creditors as a whole.
- Because the receivership process generally is quicker than bankruptcy, a troubled company is less likely to fail because of cash shortages, fatigue, or the rigors of bankruptcy.
- Assets may be sold free and clear of liens

D. DISADVANTAGES

The receivership does have several important limitations. These include the following:

- No preference power
- Limited jurisdiction
- No automatic stay
- Advisory opinion or guidance may not be permitted
- No discharge

IV. BANKRUPTCY ALTERNATIVES

A. INTRODUCTION

The federal Bankruptcy Code provides several alternative strategies for liquidating a troubled company. These alternatives include a chapter 7 liquidation or a chapter 11 liquidating plan, the latter alternative usually tied to the tactical use of section 363 sales of substantially all the assets of the debtor. Often, the core of the decision rests on whether the debtor seeks to retain control of the liquidation process. If control is irrelevant, than a chapter 7 case is an attractive alternative. If control is important, or there is an attempt to use a bankruptcy case to manage insider derivative liability, then a

chapter 7 case should be eschewed and a chapter 11 liquidating plan thoroughly considered.

B. ADVANTAGES

A bankruptcy case has several advantages over its state law cousins, including

- Nationwide jurisdiction and service of process
- Robust discovery powers
- Management control of the process (Chapter 11)
- Automatic stay
- Fraudulent transfer and preference powers well established
- Favorable federal and state tax consequences
- Discharge
- Sell free and clear of liens
- Equitable subordination
- Surcharge of collateral

C. DISADVANTAGES

A bankruptcy case has several disadvantages, including:

- Increased cost

- Greater procedural formalities
- U.S. trustee oversight
- Loss of control
- Adverse publicity
- Regulation of professional retention and compensation
- Peculiar disclosure requirements

V. CONCLUSION

An attorney must seriously consider all options when working with his or her client in developing a proactive plan to address business financial distress. One size does not fit all. There is sufficient variety in facts and circumstances to necessitate a careful, deliberate, and fresh look at each business distress context, ensuring that simple culture or habit do not drive counsel to a particular option when the facts and circumstances suggest another.