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DISTRESSED BUSINESS' ALTERNATIVES TO BANKRUPTCY

In this article the authors give an overview of various non-bankruptcy alternatives for distressed companies. These include: assignments for the benefit of creditors, UCC Article 9 sales, receiverships, and other out-of-court workout options. Their discussion covers the pros and cons of each strategy.

By Gary P. Segal, Deborah D. Williamson, and Paulina Garga-Chmiel *

Distressed businesses that are facing severe financial difficulties often think that bankruptcy, whether a Chapter 11 reorganization or Chapter 7 liquidation, is the only way to solve their problems. While bankruptcy is certainly an option, it may not be the only or even the best path to restructuring, financial stability, or otherwise orderly closing of the business operations. Bankruptcy can be costly, time-consuming, and, in some instances, result in more harm to stakeholders on both sides of the creditor-debtor relationship. There are numerous non-bankruptcy alternatives for distressed businesses and, while each will come with pros and cons, those alternatives can provide advantages to various stakeholders over a traditional bankruptcy filing. Bankruptcy practitioners and other professionals need to understand these alternatives and be able to evaluate and then advise whether one of them would better suit the needs of their client.

A number of factors should influence what route a struggling business should take: the ultimate goals of the business management, identity of creditors and their willingness to cooperate, existence and types of assets, and any guarantor's or equity holder's liability exposure, to name a few. When considering the alternatives to bankruptcy, practitioners should evaluate the following alternatives: (1) Receivership, (2) Assignment for the Benefit of Creditors, (3) UCC Article 9 Sale, (4) Compromise with Creditors and Out-of-Court Workout, and (5) Wind-Down of Business Operations.[1] The pros and cons of these alternatives are discussed in this article.

RECEIVERSHIP

A receivership is an alternative to bankruptcy, which features court oversight of the operation or liquidation of a distressed business and its assets. A receiver is an officer of the court[2] whose powers flow from either a state specific statute, common law, applicable rules of civil procedure, the order appointing the receiver, and

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[1] There are potentially dozens of possible alternatives to bankruptcy that go by different names and are appropriate for specific factual scenarios. These are more common alternatives that may be referred to by different names by different practitioners.

[2] *S.E.C. v. Elliott*, 953 F.2d 1560, 1577 (11th Cir. 1992).

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those acts expressly authorized by the appointing court.[3] Unlike a trustee appointed pursuant to Chapters 7, 11, or 13 of the Bankruptcy Code, a court appointed receiver does not take title to the property of the debtor, but rather holds the property as a custodian during the pendency of the receivership. Both federal and state courts have broad discretion to appoint receivers for a variety of purposes, and have a great amount of flexibility in determining the receiver's duties, function, and scope of authority.[4] A receivership is an amalgamation of certain principles inherent in both bankruptcy and agency law.[5] Generally speaking, a receiver is a fiduciary tasked with preserving and maintaining assets, preventing waste, and preserving value pending final adjudication. In state court, a receiver is most often appointed at the request of a secured creditor that fears that its collateral will be dissipated or otherwise harmed by the debtor or otherwise.[6] Receivers are often used when a secured lender is foreclosing upon commercial real estate. A secured lender may petition the court for the appointment of the receiver to preserve and safeguard the underlying real estate subject to the mortgage being foreclosed and to collect rents and other income from the property.

In the state court receiverships, unless specifically codified, the power to appoint a receiver arises from a state court's equitable power to manage the property interests at-issue in a lawsuit and within the court's jurisdiction during the pendency of the lawsuit. A proponent of a receivership must provide proper grounds for appointing the receiver to obtain an initial judicial determination; and being an equitable remedy, there are certain equitable factors that courts will consider in making this determination. In addition, many states have statutes governing the appointment of receivers in certain circumstances (such as mortgage foreclosures), and courts will sometimes enforce contractual consent provisions with respect to appointment of a receiver in certain situations. Additionally, secured creditors of distressed operating companies may also initiate state court receiverships. A receiver in this type of receivership is not required to liquidate the company, but instead may be granted the authority to operate the business and maximize returns, until the receiver can conclude an orderly sale of the operating business as a whole.

In federal courts, the appointment of the receiver is authorized by Fed. R. Civ. P. 66[7] and is an ancillary relief during the pendency of a federal court action asserting other substantive claims.[8] The underlying action is usually a collection action filed by a lender, but can take other forms.[9] As with any other federal action, a creditor seeking appointment of a receiver in federal court must establish that such court has subject matter jurisdiction over the estate assets intended to be placed into receivership. Because creditors' rights claims are not typically based upon a federal question, diversity of citizenship and the minimum amount in controversy under 28 U.S.C. §1332 must exist to invoke federal court jurisdiction.[10] Ancillary jurisdiction arises after initial jurisdiction is satisfied by the suit. This ancillary jurisdiction allows the federal court to appoint a receiver, and ancillary subject matter jurisdiction

[3] Ralph Ewing Clark, A Treatise On The Law And Practice And Receivers § 355 at 610-11 (3d ed. 1959).

[4] *See, e.g., Consol. Rail Corp. v. Fore River Ry. Co.*, 861 F.2d 322 (1st Cir. 1988).

[5] Jonathan P. Friedland, Strategic Alternatives For and Against Distressed Businesses §1:6 (2020).

[6] *Id.*

[7] Fed. R. Civ. P. 66 ("The practice in the administration of estates by receivers . . . appointed by the court shall be in accordance with the practice heretofore followed in the courts of the United States or as provided in rules promulgated by the district courts").

[8] This paper concentrates on appointment of a receiver for a financially distressed company and not receivers appointed pursuant to an enforcement action by, for example, the Securities and Exchange Commission or the Federal Trade Commission.

[9] Andrew C. Kassner & Howard A. Cohen, *Anything but Bankruptcy!: ABCs, Receiverships and Other Alternatives*, 080405 ABI-CLE 239 (2005) note 23.

[10] *See, e.g., Inland Empire Insurance Company v. Freed*, 239 F.2d 289, 290 (10th Cir. 1956).

provides a means to oversee actions commenced by the receiver in the carrying out of the receiver's duties.[11] While a federal receivership action requires that a creditor meet certain jurisdictional requirements, it has the distinct advantage of allowing a creditor to pursue the debtor's assets in multiple jurisdictions with one filing.

The appointment of a federal receiver lies within the sound discretion of the federal court and is not a form of relief to which any party is entitled to as a matter of law. In a federal court, the determination whether to appoint a receiver is made under federal law and the party seeking a receivership must have a legal or equitable substantive right in the property that is the subject of the proposed receivership, which substantive right must amount to more than a mere claim.[12] Factors that federal courts have considered relevant to a determination whether an appointment of a receiver is warranted include fraudulent conduct on the part of defendant; imminent danger of the property being lost, concealed, injured, diminished in value, or squandered; the inadequacy of the available legal remedies; the probability that harm to the plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment; and, in more general terms, the plaintiff's probable success in the action and the possibility of irreparable injury to its interests in the defendant's property.[13]

Pursuant to 28 U.S.C.A. § 959(b), after its appointment, a federal receiver is an officer of the court and is required to manage and operate the property in accordance with the laws of the state where the property is located. While the receiver's duties vary based on the purpose of the appointment, the court order entered upon the appointment is the primary origin of the rights, powers, and duties of the receiver. For example, when a receiver is appointed to maintain the *status quo* of property, the receiver can only do just that — it has the powers of possession, operation, and control, but lacks authority to sell the property. On the other hand, when a receiver is appointed to liquidate the property, the receiver has power to sell the assets, along with a duty to maximize the recovery for creditors, subject to court approval. Receivers can also be granted the power to both operate and liquidate.

Receiverships and Bankruptcy

While receiverships are an attractive alternative to bankruptcy because of the inherent flexibility and perceived advantages to a bankruptcy case (specifically, with respect to control, speed, and costs of administration), it is important to note that receiverships also have drawbacks. While courts have equitable discretion to grant a receiver many of the same powers as those given to a bankruptcy trustee (including the right to sell estate property free and clear of liens), there are state law variations and jurisdictional limits to any receiver's authority to administer the assets of a distressed business and a receivership does not automatically prevent the commencement of an intervening bankruptcy case.[14] As a practice tip, the order appointing the receiver can grant sole authority to file a bankruptcy case to the receiver.

In fact, receiverships are often a prelude to a bankruptcy. Creditors pursue receiverships to get property and business's assets out of the hands of management they no longer trust. In many instances, this results in the business' management pursuing bankruptcy to regain control of the assets and the process, which filing may require the receiver to turn over property of the receivership estate to the bankruptcy trustee or back to the debtor.

ASSIGNMENT FOR THE BENEFIT OF CREDITORS

An Assignment for the Benefit of Creditors ("ABC") is when the distressed business assigns all of its assets to a neutral third party, who takes title to such assets "in trust," sells them, and distributes the proceeds to creditors according to their relative priorities (as discussed below). An ABC offers some of the same advantages as a Chapter 7 filing or liquidation under 11 U.S.C. § 363, in that there is a structure for the liquidation of assets, but provides a more streamlined process that takes less time to complete and allows both the business' management and its creditors an input. An ABC is also similar to a receivership with the use of neutral third party, but that third party is not necessarily appointed or supervised by the court.

The laws governing ABCs vary greatly from state to state, with some states having statutory schemes and

[11] Kassner & Cohen, *supra* note 23.

[12] *Waag v. Hamm*, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998).

[13] CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2983 (2d ed. 2016), note 49.

[14] New York City Bar Association, Committee on Bankruptcy & Corporate Reorganization, Non-Bankruptcy Alternatives to Restructurings and Non-Bankruptcy Alternatives to Restructurings and Asset Sales at pp. 24–25 and Friedland at §11:14.

others using common law or not using the process at all, with and without court oversight of the proceedings. Nonetheless, whether court-supervised or not, the basic process for an ABC is as follows:

1) upon acceptance of the assignment, the assignee gives notice of the assignment to creditors;

2) creditors are provided with a reasonable period of time (from 60 to over 180 days depending on the applicable state statute) to file proofs of claim with the assignee to be included in the pool of creditors that will share in the proceeds from the liquidation of assets;

3) the assignee determines the best option for the liquidation of assets and then liquidates such assets;

4) the sale proceeds are applied against creditors' claims in the order of priority; and

5) the assignee ends the administration of the assignment estate when all assets are liquidated and sale proceeds distributed.[15]

The priority of payment is also subject to state statute, which generally provides that the proceeds are distributed first to secured creditors (to the extent that the assets are subject to a valid and perfected lien), then administrative fees and expenses, then claims of any agency or the federal government, priority wages, unpaid state and local taxes, allowed general unsecured creditors' claims, claims of equity holders, and late-filed claims.[16]

While the assignee has discretion as to how best to liquidate the business' assets, whether through a liquidation or a bulk sale, as a fiduciary for creditors, the assignee has a duty to act diligently to maximize the return for the creditors.[17] Creditors can challenge the validity of an assignment or even seek removal of the assignee for breach of fiduciary duty — either in state court proceedings or in the bankruptcy court by filing of an involuntary chapter 7 bankruptcy. Notably, under Section 303(h) of the Bankruptcy Code, creditors can initiate an involuntary chapter 7 bankruptcy case, overcoming opposition of the debtor, solely on the basis of the appointment of the assignee or taking of possession of the debtor's property within 120 days prior to the filing of the involuntary petition.[18] However, under section 305(a)(1), a bankruptcy court "may dismiss" a bankruptcy case or "may suspend all proceedings" if "the interests of creditors and the debtor would be better served by such dismissal or suspension."[19] In making that decision, the bankruptcy court would consider a few non-exclusive factors, such as: the economy and efficiency of administration; whether another forum is available; a state court proceeding is already pending; whether federal proceedings are necessary for a just and equitable solution; whether an alternative exists for achieving an equitable distribution; whether a less expensive and better out-of-court arrangement is possible; whether the ABC has proceeded so far that starting over in bankruptcy would be costly; and whether bankruptcy jurisdiction is sought for a proper purpose.[20] As such, there is a strong interplay between the ABC and bankruptcy.

As with any of the discussed alternatives, the ABC also comes with its own pros and cons. ABCs can be effectively employed where both the business' management and its creditors agree that liquidation is the right choice, but want more direct control over the liquidation than would be provided by a Chapter 7 filing. From a creditor's perspective, an ABC offers a way to quickly remove management from day-to-day control of the assets and is usually far less publicized than a bankruptcy filing.[21] An ABC can also be an effective tool for selling all the assets of a business to a third party as a going concern. However, the ABC does not offer the business and the stakeholders the advantages of the Bankruptcy Code — the automatic stay, the transparency and disclosure requirements, or a universal discharge of debts. Also, assets sold through an ABC do not automatically have a clear title. For example, a secured party would have to release its lien to provide a buyer with title without such secured party's lien. An ABC may not be a good option where there are a large number of creditors, or there are disputes about the priority of creditors, as it is possible that such issues would end up being litigated in the future. Further, if there are dissenting shareholders, an ABC might be practically impossible if the governance documents or applicable state law requires that a transfer of substantially all of

[15] Friedland, *supra* at §8:2.

[16] *Id.*

[17] *In re Scandia Seafood (New York), Inc.,* 2017 Bankr. LEXIS 1298, *18 (Bankr. S.D.N.Y 2017).

[18] 11 U.S.C. § 303.

[19] 11 U.S.C. § 305(a)(1).

[20] *In re Scandia Seafood (New York), Inc.,* 2017 Bankr. LEXIS 1298 at *18.

[21] *Id*.

the assets be with consent of the shareholders after a properly noticed hearing.

UCC ARTICLE 9 SALE

Article 9 of the Uniform Commercial Code ("UCC") governs the relationship between a debtor and its secured creditors, and provides a comprehensive statutory scheme for creating, perfecting, and enforcing security interests in personal property and fixtures to secure an obligation. The UCC has been adopted nationwide, with relatively minor variations among the states.

A secured creditor's remedies under Article 9 of the UCC include repossession, disposition, and retention and acceptance of collateral to satisfy the underlying obligations. A secured creditor may pursue these remedies with a debtor's consent in "friendly" situations, but ultimately the debtor's consent is not required.[22] In an absence of debtor's agreement to surrender the collateral, Article 9 of the UCC allows a secured creditor to repossess the collateral — either via self-help or utilizing a judicial process.[23] Not surprisingly, self-help repossession is the fastest and most cost-effective means of repossessing inventory and equipment because it does not require the time and expense of obtaining a court order. However, self-help repossession typically poses risks because the creditor must ensure that it does not breach the peace when acting.[24] If the creditor or its agent causes a "breach of the peace," or wrongly repossesses the collateral, the creditor may be liable for any loss caused by such breach of the peace, as well as the debtor's inability to obtain, or the increased costs of, alternative financing, plus $500 payable to the debtor.[25] The UCC does not define a breach of the peace, so specifics would have to be analyzed under applicable state law. A secured party is responsible for its agent's actions (including law enforcement) and will face liability for any unreasonable repossession conducted on its behalf by an independent contractor. Notably, a secured party and the debtor cannot waive the breach-of-peace requirement or contractually define a breach of peace because the requirement protects the general public and others who are not in contractual privity.[26] Thus, secured creditors may consider discontinuing self-help repossession when faced with resistance from a debtor or third party and instead seek assistance from the court in a judicial process.

Finally, after obtaining possession of the collateral, pursuant to Section 9-610 of the UCC, a secured creditor may dispose of its collateral via a UCC sale — either a private or a public sale. As the name suggests, a UCC public sale is similar to a public auction, whereas in a private sale, secured party seeks out interested parties and agrees on sale terms without an auction. For both private and public UCC sales, the UCC provides statutory protections to the debtor. These protections include specific notice requirements under Sections 611, 612, 613, and 614 of the UCC, and a "commercially reasonable" requirement under Section 610(a) of the UCC.

Under section 627 of the UCC, the disposition of assets is considered commercially reasonable if made in the usual manner on recognized market, at a price current on that market, and otherwise in conformity with reasonable prices among dealers in the type of property that was subject of the disposition.[27] The question of commercial reasonableness is likely the most litigated topic under Article 9 and generally speaking, in their determination, the courts consider secured party's efforts to find a buyer (i.e. general and specialized advertising/solicitations, use of a broker, websites, and auctioneer), the location of sale and access for bidders (which has become a hot topic during the pandemic due to social-distancing and other prohibitions of public gatherings), whether secured party provided adequate information about the collateral and an opportunity for due diligence review, and whether the terms of the sale included arbitrary and unreasonable restrictions (i.e., restrictions on bidders and proof-of-funds requirements). Notably, the actual purchase price for the collateral is not determinative of the commercial reasonableness. However, section 9-615(f) includes an anti-deficiency provision, which is triggered when the collateral is sold to the secured creditor or a related party at a price that is significantly below the range of proceeds that would have been produced at a sale to a third party.

A UCC sale is an attractive remedy for a secured creditor as it allows such creditor to be in control of the disposition of the assets and quickly and rather inexpensively liquidate their collateral. It could also be

[22] A secured creditor may take possession of its collateral in a strict foreclosure pursuant to Sections 9-620 and 9-621 of the UCC. Often referred to as "Friendly Foreclosure," under Sections 9-620 and 9-621, the debtor consents to the creditor foreclosing on its collateral. Once under the control of the creditor, the collateral can be sold or used by the creditor.

[23] U.C.C. §9-609.

[24] U.C.C. §9-609(b).

[25] U.C.C. §§9-609(b) and 9.625(b) and (e).

[26] U.C.C. §§9-602 and 9-603(b).

[27] U.C.C. §9-627.

an attractive option for a distressed business. First, debtor's acquiescence to surrender of the collateral and the sale may provide the debtor with an important leverage — especially if the debtor or other obligors seek to extinguish their personal liability. Second, provided the secured creditor has followed required notice provisions (providing notice to the debtor, other obligors, and all subordinate creditors in a timely manner), the collateral is sold "free and clear" of junior liens. Unlike a sale under Section 363 of the Bankruptcy Code, a UCC sale is not free and clear of senior liens, which may include statutory liens.

COMPOSITION AGREEMENTS, EXCHANGE OFFERS AND OUT-OF-COURT "WORKOUTS"

While not always a realistic option for a distressed business, restructuring its balance sheet directly with creditors, as an out-of-court "workout," can offer great efficiency, cost savings, and minimize any detrimental effects on the business as compared to bankruptcy. The ultimate goal of a workout is to negotiate a consensual solution with the creditors to adjust the business' obligations to pay liabilities or the timing thereof to be more in-line with the available cash flow. The form that a workout takes depends on the specific nature of the business' financial distress and capital structure, but typically involves a reduction in the principal amount of debt and/or an extension of the maturity of debt, and possibly the issuance of new equity.

Composition agreements may be used with multiple creditors of a distressed business. A composition agreement is an agreement made between a debtor and multiple creditors whereby each of the creditors entering into the arrangement agrees to be paid a specified amount, possibly on a deferred schedule, in full satisfaction of the debt.[28] A composition agreement is negotiated out of court between the creditors and the business, and is binding against consenting parties in any subsequent judicial proceeding. It is akin to an out-of-court Chapter 11 as it reforms a business' obligations to its creditors while preserving the business as a going concern.

Exchange offers are similar to composition agreements, except the creditors would be a specified class of creditors, like bondholders of a specified class of lenders. In an exchange offer, bondholders are offered an opportunity to exchange their existing bonds (existing securities) for new debt, equity, or some combination of both (new securities), in order to reduce the amount or change the timing of the issuer's principal and interest payments. Typically, the new securities package may feature a mix of debt and equity, a lower coupon, a delayed sinking fund, or lengthened maturity.[29] Depending upon the agreements governing the class of creditors (such as a trust indenture or credit agreement), less than 100% of a class of creditors might be sufficient to effectuate an exchange offer. An exchange offer may involve some issues with tax and securities laws. A good exchange offer will often contain the following: (1) an analysis of the current financial position, (2) an analysis of the existing agreements governing the creditors' agreements (such as trust indenture or credit agreement), (3) an expected recovery or expected outcome for such class if the exchange offer is not accepted, (4) a description of the term of the proposed new securities, and (5) a description of the process, timing, and required votes for the acceptance of such exchange offer.

Composition agreements and exchange offers allow a business to restructure its balance sheet without the time, expense, and publicity of a bankruptcy proceeding. Such speed, the reduced costs, and less publicity would be expected to preserve credibility with the business' customers and suppliers. They have reduced costs because they avoid some or all of the expenses related to trustees, committees, multiple groups of financial advisors, as well as other administrative expenses in a typical bankruptcy case. Such cooperation between debtors and their creditors also avoids the time, cost, and uncertainty of litigation. Composition agreements have the added benefit of being attractive to creditors that have an interest in the debtor's ongoing survival, such as a vendor looking to sell more product to the business in the future.

Composition agreements and exchange offers have some disadvantages when compared with bankruptcy proceedings. They cannot bind non-consenting creditors (unless contractually obligated pursuant to the specific terms of an indenture or other agreement), and therefore may not prevent an involuntary bankruptcy from being filed. Additionally, the business does not benefit from the Bankruptcy Code's protections, such as an automatic stay or the ability to reject burdensome executory contracts.

WIND-DOWN OF BUSINESS OPERATIONS

Finally, a distressed business may benefit from a voluntary wind-down of its operations and liquidation of

[28] Friedland, *supra* at §7:1.

[29] *Id*. at §1:7.

its assets. The biggest advantage of a voluntary wind-down is that management of the business controls the process, at its chosen pace, with or without the help and cost of additional professionals. However, a voluntary wind-down creates risks and uncertainty for customers, employees, creditors, and other stakeholders. With the business being wound down, existing customers will be required to find other sources of products or services that were being supplied by the business, and employees will be looking for new jobs. As a result, prices may be adversely affected and expenses may increase if temporary help is necessary. There may also be some notice requirements when terminating employees, and associated severance and termination costs.[30] Since the existing management is in charge of the process, there is no independent review or consultation to make sure that assets are sold at market or fair prices. If creditors find out about the voluntary wind-down, they might not trust the process or believe that management in charge of the process is properly addressing their concerns, and therefore decide the file an involuntary bankruptcy petition or other process, each of which would end the voluntary wind-down process. Additionally, voluntary wind-downs don't have the benefit of the automatic stay provided by bankruptcy, so management might have to deal with creditor collection or enforcement actions at the same time they are trying to wind-down the business in an orderly manner. Furthermore, under some business or statutory structures, such as a general partnership or secured debt, management will have to get other stakeholders involved in the wind-down.[31] Finally, buyers of assets in a wind-down may option prefer to purchase assets through a more formalized process, such as a sale under section 363 of the Bankruptcy Code or a UCC sale in an effort to limit issues with liens, defects in title, and future litigation concerning the value of consideration paid or successor liability.

CONCLUSION

Bankruptcy is the most widely used and familiar forum for addressing creditor-debtor issues. The benefits of the bankruptcy system are well known to bankruptcy practitioners and include its predictability, its well-established rules and precedent, and the statutory protections it provides to both creditors and debtors. On the other hand, bankruptcy filings are often expensive, highly exposed, lengthy, and complicated judicial proceedings that can leave both debtors and creditors unhappy with the final outcome. There are numerous non-bankruptcy alternatives and, while they come with their own pros and cons, those alternatives can provide both creditors and debtors with advantages over a traditional bankruptcy filing. Practitioners need to be familiar with alternatives to bankruptcy so that they can properly counsel their clients about the options. ■

[30] Worker Adjustment and Retraining Notification Act (29 U.S.C. §§ 2101-2109) or similar state statutes.

[31] *See, e.g.,* the saga of IN RE STREAM TV NETWORKS, INC. Omnibus Agreement Litigation, case number 2020-0766 and *Hawk Investment Holdings Ltd. v. Stream TV Networks Inc. et al.*, case number 2022-0930, both in the Court of Chancery of the State of Delaware.