

For Bankruptcy Alternative, Know Your ‘ABCs’

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Biotech Corporation is a fictitious biotechnology company that has burned through more than \$150 million in equity provided by private investors and venture capital firms since it was formed three years ago. The company has no secured debt, but it has incurred more than \$30 million in unsecured debt that it is now unable to pay.

While Biotech has developed some exciting products and passed important research and development milestones, such as U.S. Food and Drug Administration clinical phase approvals, it continues to operate with a negative cash flow, and venture capital sources have dried up.

At this point, the company is insolvent by traditional standards. The company's legal counsel has advised the board of directors that, under the circumstances, its fiduciary obligation is to the company's creditors and that it is required to act in a manner reasonably designed to maximize creditor recovery.

The board has determined that a going concern sale of the business is in the best interests of the company and its creditors. It has identified two potential purchasers, but neither is willing to acquire the business if it must assume the company's unsecured debt. In the meantime, the situation is deteriorating rapidly. Biotech is burning through its cash reserves. Key employees are aware of its financial difficulties, and many of them are circulating resumé's. Creditors, including some important sole-source suppliers, are pressing for payment.

Legal counsel has advised the company's board of directors that a general assignment for the benefit of creditors (ABC) is the most



appropriate course of action. An ABC could facilitate a quick going concern sale of Biotech, the preservation of jobs for many of its employees, and the transfer of its assets to the successful purchaser, free from the company's unsecured debt.

Laws Vary

An ABC is a business-liquidation device that can provide a graceful exit strategy for an insolvent debtor as an alternative to formal bankruptcy. It provides a framework for the wind-down of a company and payment of its creditors that helps minimize potential liability for directors and management.

An ABC can provide a useful and efficient means to maximize a secured creditor's recovery from the assets of a distressed debtor and facilitate a buyer's acquisition of a troubled business or its assets, free of unsecured debt (and, with the cooperation of any secured creditors, secured debt).

Unlike federal bankruptcy proceedings, ABCs are governed by state laws. A distressed entity, the assignor, commences an ABC by entering into a contract with a party known as the assignee to conduct a wind-down and/or a liquidation or going concern sale. The assignee serves in a fiduciary capacity for the benefit of the assignor's creditors in the transaction.

The assignment agreement is a contract under which the assignor (Biotech, in this example) transfers all of its rights, title, interest in, and custody and control of its property in trust to an assignee, which liquidates the property and distributes the proceeds to the creditors. Unsecured creditors have no right to pursue the assets assigned to the assignee, but rather must submit proofs of claims. If a claim is allowed, creditors participate in the assignee's distribution of funds from the assignment estate.

To commence an ABC, a distressed corporation generally must obtain authorization from both its board of directors and its shareholders. Although shareholder approval is not required for a corporation to file a bankruptcy petition, most states require such consent for an ABC because the process constitutes a transfer of all of an assignor's assets to an assignee. This requirement can be an impediment to the quick action typically available through an ABC, especially for a public company. However, public companies have implemented ABCs successfully.

California is the "capital" of ABCs. Governed by common law and subject to various statutory provisions, the ABC process in the state is non-judicial. Other states, such as New York, have detailed and comprehensive

statutory schemes governing ABCs that require judicial involvement. Still others have laws governing ABCs that fall somewhere between those of California and New York.

While laws vary from state to state, in general an assignee serves in a capacity analogous to that of a bankruptcy trustee. The assignee is responsible for liquidating the assets of the estate and distributing the net proceeds to creditors.

In many cases, the common law assignment by simple transfer in trust is a preferable liquidation mechanism, compared to the more cumbersome federal statutory procedures governing Chapter 7 liquidation or liquidating Chapter 11 cases. ABCs may involve less administrative expense and provide a faster and more flexible liquidation process.

In addition, unlike a Chapter 7 liquidation, in which an unknown trustee generally is appointed to administer the liquidation process, an ABC permits an assignor to select an assignee with appropriate expertise to conduct the wind-down and liquidation of its business. In prepackaged ABCs, in which an immediate going concern sale is to be implemented following the assignment, the assignee is involved before the ABC becomes effective. This cannot be done in a Chapter 7 case because the trustee is not known or appointed until after the bankruptcy petition is filed.

Substantial Discretion

In states that have instituted non-judicial ABC processes, an assignee has substantial discretion in structuring the liquidation of an assignor's assets. The general standard is that the assignee must exercise reasonable business judgment in a manner designed to maximize creditor recovery. In a prepackaged ABC, there is no requirement that the transaction be subject to overbid opportunity. However, the assignee must feel comfortable that it is exercising its fiduciary duty to creditors appropriately under the circumstances.

In Biotech's case, the assignee would need to determine which of the two offers was most advantageous to the company's creditors. Frequently, such decisions are judgment calls by assignees because transactions do not always involve straight cash offers. Some may involve other consideration, such as notes payable over time. An assignee may have to weigh offers from buyers who are interested in buying various components of an assignee's business against others who seek to acquire the entire business. Professionals considering

serving as assignees should weigh the risks carefully because their business judgment may come under attack after the fact.

In states that have adopted non-judicial ABC processes, an assignee's compensation is generally not dictated by statute. Payment is frequently structured as the greater of a minimum fee amount or a percentage of proceeds from the liquidation of the assets, often between 4 percent and 10 percent, depending on the type of assets at issue and the circumstances involved.

The only issue that parties can challenge after a post-assignment sale is whether an assignee appropriately exercised its fiduciary duty to maximize creditor recovery.

However, other compensation arrangements are common. An assignee may receive a minimum fee plus incentive compensation in the form of a percentage of the consideration administered by the assignee and/or distributed to creditors. An assignee also may be compensated at hourly rates, a flat fee, incentive compensation, or a combination of approaches.

Under Uniform Commercial Code (UCC) Section 6-103(3)(f), an ABC is not governed by bulk sales laws. Further, an assignee holds the rights of a lien creditor who has priority over those who hold unperfected security interests and, of course, over those holding unsecured claims. Accordingly, while it carries no court approval, a sale made as part of a non-judicial ABC cuts off successor liability.

The sale is conducted by a fiduciary under a liquidation process specified by state law. It is outside the scope of fraudulent transfer because the sale is made by an assignee and not by an entity against which creditors hold claims.

The only issue that parties can challenge after a post-assignment sale is whether an assignee appropriately exercised its fiduciary duty to maximize creditor recovery. In a rapidly deteriorating situation, such as Biotech's, quick action is required and therefore, an assignee can exercise discretion to maximize creditor recovery.

The ABC process removes from a company's board of directors and management the responsibility for and exposure from winding down the business and disposing of its assets.

SEC regulations requiring directors to disclose their prior involvement with companies that filed bankruptcy may not be triggered by an ABC, although this issue should be reviewed by securities counsel in specific cases.

From a buyer's perspective, acquiring a going concern business or the assets of a distressed entity in an ABC transaction provides some important advantages. Most sophisticated buyers will not acquire an ongoing business or substantial assets from a financially distressed entity that has outstanding unsecured debt unless the assets are "cleansed" through either an ABC or the bankruptcy process. Buyers are generally unwilling to risk exposure to potential fraudulent transfer claims and successor liability.

Creditors submit proofs of claims to the assignee and receive pro rata payments from the proceeds of the assignment estate. Although they vary from state to state, priority schemes for paying unsecured obligations are set forth in an ABC. Generally, for example, claims for wages earned within a specified period prior to an ABC, up to a maximum amount, are granted priority treatment, as are tax claims. Also, federal law provides that an assignee "paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government."

Some state statutes also grant assignees the right to recover preferences and fraudulent transfers. Furthermore, state preference and fraudulent-transfer statutes may be used by trustees in conjunction with bankruptcy cases if they are more advantageous to the estate than the Bankruptcy Code's preference or fraudulent-transfer provisions.

Rather than going through foreclosure, a secured creditor in certain circumstances may prefer that a third party experienced in liquidations in the distressed company's industry act as assignee. If a secured creditor holds valid perfected liens on assets that are sold, there is nothing improper with an assignee entering into appropriate subordination agreements with the secured creditor, liquidating the assignor's assets, and turning over the proceeds to the secured creditor.

Liquidation Processes

The liquidation process in an ABC can take many different forms. In some instances, negotiations between a buyer and the assignee commence before an assignment is made, and a prepackaged transaction is agreed upon and



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implemented contemporaneously with the execution of the assignment. This type of turnkey sale can effectively allow a purchaser to acquire a company with no interruption in business operations.

In other cases, an assignee may operate a business post-assignment while pursuing its sale as a going concern. However, the assignee must weigh the risks and costs of continuing to operate the business against the anticipated benefits of a sale.

Often, a distressed enterprise has ceased operations prior to making the assignment, or it plans to halt business operations at the time the assignment is made. In these cases, an assignee may sell the assets in bulk, or it may sell or license key assets and liquidate others through auctions or other private or public sales.

An out-of-court workout or liquidation carries the risk of an involuntary bankruptcy petition being filed against a debtor while the process is underway. Under Bankruptcy Code Section 305, however, such a risk is substantially lessened if a process such as an ABC is already in place to facilitate the liquidation of the debtor's assets and distribution to creditors.

In determining whether to abstain from exercising jurisdiction over an involuntary bankruptcy case, courts consider a variety of frequently overlapping factors, including:

1. The efficiency and economy of administration, with an eye toward avoiding unnecessary duplication of efforts.
2. Alternatives to achieve an equitable distribution of assets, including whether a non-federal insolvency process has advanced to a point that it would be costly and time-consuming to start fresh with the federal bankruptcy process.
3. The lack of any advantage to creditors by invoking federal bankruptcy jurisdiction and/or the lack of prejudice to parties resulting from the bankruptcy court's abstention and dismissal of the involuntary petition.
4. The motivation and/or purpose of the parties seeking to invoke federal bankruptcy jurisdiction.

Generally, courts abstain from exercising jurisdiction and dismiss involuntary bankruptcy petitions filed after a debtor has made an ABC. Bankruptcy Code subsections 543(a) and (b) provide that a "custodian" (this term includes an assignee) appointed prior to the filing of a bankruptcy petition must generally cease from administering an estate's property (except as is necessary to preserve such property), turn over the property, and make an accounting to the bankruptcy trustee. This would not be required, however, if the bankruptcy court abstains from exercising jurisdiction and dismisses the involuntary petition.

Furthermore, Section 543(d)(1) of the Bankruptcy Code provides an exception to the turnover requirements if the interests of creditors and equity holders (for a solvent debtor) would be better served by permitting the custodian to continue in possession, custody, and control of the property. Congress, in Section 543(d)(2), also specifically exempted assignees that are appointed and take possession of debtors' properties more than 120 days before the filing of bankruptcy petitions from complying with the turnover requirement and the restrictions against administering the estates' properties, unless it is necessary to prevent fraud or injustice.

Conclusion

ABCs can be particularly useful when fast action and/or industry expertise is needed to recover value from the liquidation of a troubled enterprise. The process can allow the parties to avoid potential delays and uncertainty of formal federal bankruptcy court proceedings.

In many instances involving deteriorating businesses, management engages in last-ditch efforts to sell the business in the face of mounting debt. However, the value of the business frequently is diminishing rapidly as, among other things, key employees leave. Moreover, the parties interested in acquiring the business and/or assets generally will move forward only if they will not be taking on the unsecured debt of the distressed entity along with its assets. In such instances, an ABC can be a viable option. ^{CR}

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