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Bankruptcy Alternatives

OVERVIEW

There are many ways of handling the affairs of insolvent or financially distressed business debtors. One is to keep the debtor in business and restore the business to profitability. Another is to put the debtor out of business, sell the assets and distribute the proceeds among creditors.

Creditors usually prefer to rehabilitate a distressed debtor by voluntary out-of-court settlement. When rehabilitation is not possible they may liquidate assets outside of bankruptcy proceedings through a general assignment for the benefit of creditors. The credit professional who is familiar with both of these methods, and their advantages and disadvantages, will be able to participate effectively in whatever action is taken when a customer becomes insolvent.



THINK ABOUT THIS

- Q. How can alternatives to bankruptcy be advantageous to both the debtor and its creditors?
- Q. How can the time of the settlement payment affect the amount the creditor receives?



DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- ✓ How to identify a financially distressed debtor.
- ✓ What is involved in a voluntary settlement of claims.
- ✓ The different kinds of settlement plans.
- ✓ The different methods of resolution.
- ✓ The two types of assignments for the benefit of creditors.
- ✓ How to evaluate settlement offers.

CHAPTER OUTLINE

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Identifying the Distressed Debtor

Prompt action must be taken if a distressed debtor is to be restored to solvency and maintained as a customer. Credit professionals learn to recognize symptoms of approaching business difficulties through experience, investigation and analysis.

Warning Signs

The credit professional should watch for changes in a customer's business behavior that may signal financial distress. There are several warning signs:

- The debtor has stopped taking advantage of available discounts.
- There is a general slowdown in payments to vendors.
- Lawsuits are being filed against the debtor.
- Tax or vendor liens are being filed against the debtor.
- The debtor is constantly shifting from one supplier to another.
- The debtor is in default with its lending institutions.
- The financial condition of the company is deteriorating.



Comprehension Check

List the warning signs of financial distress.

Public Information and Records

Newspapers are a primary medium to publish statutorily required legal notices because they are readily accessible by the public. By definition, **public records** are information recorded in a public office and available for public inspection. Although the types of statutorily required notices are too many to list, examples include judgments, state or federal tax liens, mechanic's liens and release of liens.

Insolvency and Non-Liquidity

In business, **insolvency** is the situation where the liabilities of a person or firm exceed its assets. In practice, however, **insolvency** is the situation where an entity cannot raise enough cash to meet its obligations, or to pay debts as they become due for payment (i.e., even if it could sell all its assets, it would still be unable to repay its debts). **Non-liquidity** occurs when a firm has a temporary cash flow problem. It is a measure of the extent that a person or organization has cash to meet immediate and short-term obligations, or assets that can be quickly converted to do this. Its assets are greater than its debts, but some assets are illiquid (e.g. it takes a long time to sell a house. A bank can't suddenly demand a mortgage loan back). Therefore, although in theory assets are greater than debts, it can't meet its current payment requirements.

Credit professionals should be able to distinguish between a business that can be financially rehabilitated and one that should be liquidated for the benefit of its creditors, in or out of a bankruptcy proceeding. Credit professionals should also be able to recognize the dishonest debtor that could be rehabilitated, but should instead be liquidated and prosecuted. Careful consideration should be given to whether a company can be rehabilitated with the current management in place or whether the rehabilitation should be under the guidance of a trustee. There may be situations where a better recovery in a workout plan with a trustee in place is more effective than a bankruptcy plan which may involve a large number of administrative claims. Management's ability to adapt to a different business perspective and plan of action may be an influential factor in this determination. Prosecution of a dishonest debtor is frequently desirable, but not always in the creditors' best interest. It takes money, usually from the estate and reduces the amount available for creditors' claims.



Comprehension Check

Explain the difference between **insolvency** and **non-liquidity**.

Figure 18-1**Handling Distressed Debtors****Exhibit 1****Reorganize the Financial Affairs**

- Formally through bankruptcy proceedings
 - Chapter 9, 11, 12 or 13
- Through non-bankruptcy proceedings
 - Voluntary Settlement such as:
 - Composition Agreement
 - Extension Agreement
 - Combination Settlement
 - Involuntary Proceeding
 - Receivership

Exhibit 2**Liquidate the Business**

- Formally through bankruptcy proceedings
 - Chapter 7 or 11
- Through non-bankruptcy proceedings
 - Voluntary Settlement such as:
 - Assignment for the Benefit of Creditors
 - Liquidation Agreement
 - Involuntary Proceeding
 - Receivership

Voluntary Settlements

A **voluntary settlement** is a contract between the debtor and its creditors that settles their claims for the most the debtor can pay and the most the creditors can realize. It keeps the debtor in business and avoids substantial bankruptcy costs that few debtors can afford under the circumstances. The creditors may take a temporary loss, but expect the debtor to emerge stable and solvent as a continuing customer. Voluntary settlements between debtors and creditors are preferred to a bankruptcy filing.

Advantages and Complications

The principal advantage of a voluntary settlement is its simplicity. There are no cumbersome court proceedings. They are essentially informal but legally binding on the debtor with specific penalties for nonperformance.

Because they are relatively uncomplicated, voluntary settlements are more economical than bankruptcy proceedings. There are no court costs and trustee fees, and the general costs of administration are lower. This means there are likely to be more assets left to satisfy the amounts due to creditors.

In some cases, the use of non-bankruptcy alternatives may not be the best option. They may be difficult to arrange when there are priority secured claims such as bank loans or tax liens on the debtor.

Initiating the Voluntary Settlement

Voluntary settlements may be initiated by either the debtor or the creditors. Most frequently, a debtor in financial difficulty goes to an attorney for advice. The attorney may consult with a few of the largest creditors and arrange a meeting to be attended by the debtor and its largest creditors. A meeting may also be initiated by a few of the most interested or largest creditors that are suspicious of the debtor's financial condition. Adjustments of debts are an alternative for creditors, as well as debtors, to attempt to gain greater recoveries on unsecured claims than might

be otherwise be possible. Where a debtor has expressed the desire to try to solve financial problems out of court, adjustment specialists can effectively assist organizing unsecured creditors to ensure fair and equitable recoveries for all creditors.

Secured Claims

Secured claims may consist of mortgages on the debtor's real property, other secured assets or any perfected security interests in property made in accordance with the Uniform Commercial Code provisions. In general, a bankruptcy discharge only eliminates personal liability for a debt. It doesn't wipe out the creditor's security interest in the property.



Comprehension Check

What may a **secured claim** consist of?

Priority Claims

Priority claims may consist of taxes, wages and unpaid rent which under federal or state laws are entitled to priority payment over unsecured claims.

General creditors should not accept voluntary settlements or extensions unless they are given absolute assurance that secured and priority claims have been adequately disposed of by the debtor. Failure to do so could result in any voluntary settlement arrangement being unenforceable. The validity of such claims should be reviewed by counsel for the creditors.



Comprehension Check

What may a **priority claim** consist of?

Settlement Plan

Working out a settlement plan is largely a matter of bargaining. Armed with the information acquired, the creditors are in a position to bargain for a settlement that will ensure maximum return to creditors, but will still enable the debtor to emerge solvent.

Voluntary settlements usually take one of three forms: extensions, *pro rata* cash settlements, or combinations settlements. Which plan evolves depends in large part upon the negotiating ability of the creditors' committee. Occasionally, a committee of creditors may arrive at a plan in which an extension is accepted by some of the creditors while a *pro rata* cash settlement payment is made to other creditors.

Importance of Unity in Voluntary Settlements

The success of a voluntary settlement depends upon the full cooperation of all creditors and the debtor. For example, a secret or previously undisclosed preferential arrangement between the debtor and even one creditor, giving this creditor a larger settlement than the others, is a valid basis for any creditor to rescind the settlement on the basis of fraud.

During the negotiation period, objecting creditors are free to sue or levy against or attach the debtor's assets in satisfaction of their claim, and taxing authorities are free to levy. One creditor or taxing authority may prevent the settlement from being consummated.

The debtor can prevent this by executing a statutory assignment for the benefit of creditors or by filing a petition under the bankruptcy laws.



Comprehension Check

Why is unity important in voluntary settlements?

Creditors' Committee

At the first meeting of creditors, a committee should be selected. This committee generally consists of five or seven of the largest unsecured creditors and perhaps one or two representatives of the larger body of smaller creditors. Although the proceedings are out of court, the committee should be limited in number, with other creditors serving as alternates or ex-officio members. Sometimes only the larger companies can spare the expense of

sending a representative to the creditors' meetings; having some of the creditor company names may lend credence to the proceedings.

The people serving on the committee must be knowledgeable in this type of work and have the time to serve and work in the best interest of all creditors. There must be complete disclosure by all members of the committee of their interests.

The committee should select a chairman, secretary and counsel. While the chairman is often from the largest creditor, it is of the utmost importance that the chairman be knowledgeable and willing to serve and work. Counsel is usually a lawyer experienced in this work, representing one or more of the larger creditors, or independent of all creditors. The counsel sometimes acts as the secretary.

The creditors should also ask that an accountant be retained to make an independent examination of the debtor's books and records at the expense of the debtor or its estate. It is most helpful to the creditors if the debtor will come to the first meeting well-prepared, accompanied by both counsel and accountant. The debtor should have current financial statements, be prepared to give the entire financial history of the business as well as the reasons for its distressed condition, and be able to answer most questions.

It is possible, but unlikely, that a satisfactory plan of settlement will be agreed upon at the initial creditors' meeting. In order to assess any settlement plan the debtor proposes, the creditors need their own evaluation of the debtor's business and financial situation.



Comprehension Check

Explain the important requirements of a creditors' committee.

.....
What items should be examined by the creditors' committee?

Objects of the Investigation

The creditors should obtain an up-to-date inventory count and valuation if appropriate. One or more members of the creditors' committee who are experts in the type of business may evaluate the inventory, or an appraiser may be retained, at the expense of the debtor or its estate. It is important to ascertain what the assets would realize at a forced sale; this is an indication of what the dividend might be in bankruptcy proceedings and sets the floor for a voluntary settlement. Creditors should request copies of tax returns for the last several years to determine the changes that have occurred and whether they were completed and filed properly.

Causes of Financial Distress

Creditors should try to ascertain the reasons for the current financial distress: excessive rent and overhead, high general and administrative expenses which include salaries, unusually large withdrawals from the business, declining sales volume, or inadequate markup on goods. Questioning the debtor about these matters can help determine whether a workout with a 100 percent payment or reduced settlement amount is the better goal. The answers should help decide the size of a proposed settlement and whether the offer is the best possible. During its investigation, the creditors' committee may uncover indications of dishonesty or lack of management skills. If the committee determines that the business is viable, but management is lacking, a turnaround consultant or management evaluation firm may be considered. The debtor that remains outside of a formal bankruptcy statistically has a better chance of survival, improving the chances that creditors can be repaid and the relationship with the debtor as a paying customer can be reestablished.



Comprehension Check

List the causes of financial distress.

Questionable Actions by Debtor

These include:

- Sudden increases in purchases without corresponding increases in sales.
- Materially false financial statements.
- Unaccountable or unexplained reduction in inventory or cash.
- Recent repayment of loans.
- Pledging of assets.

- Missing financial records.
- Evasiveness by the debtor in answering questions or supplying information.
- Big salaries or expense accounts.

Reaction of Creditors' Committee

In such instances, the reaction of the creditors' committee to the debtor may be unfavorable. The committee may decide that court proceedings are preferable, with opportunities for investigating fully, denying the debtor a discharge from its obligations, or even imposing criminal sanctions. The committee may decide to retain a forensic accountant to piece together how the decline happened.

Positive Findings by the Creditors' Committee

If the committee finds that the debtor has been honest and a worthwhile customer in the past and that the business can be saved, it should ask the debtor to present a plan. A review of the debtor's buying and payment history may enable the creditors to assist the debtor with a plan that would work for everyone's benefit. The goal is to rehabilitate and retain a previously valuable customer.

Methods of Resolution

Alternative Dispute Resolution

The increasingly complex nature of commercial agreements and the substantial delays and expense associated with litigation have given rise to alternatives for accommodating the needs of creditors when disputes occur. There are two types of **alternative dispute resolution (ADR)**, or ways to resolve conflicts between parties without litigation; *mediation and arbitration*. While not totally inconsistent with one another, arbitration and mediation are different and have their own uses.

Normally, both parties must agree to use ADR, making it appropriate for voluntary settlements. Mediators and arbitrators are neutral, they represent neither side. Each of the parties in a voluntary settlement should have its own legal counsel for the ADR process.

Mediation

Mediation is the non-binding attempt by parties to solve a dispute using an independent mediator or facilitator in order to allow the parties to reach common ground. Unlike arbitration, mediation can be chosen after the dispute has arisen. The parties usually select and agree upon a qualified, skilled and experienced mediator.

The mediator's role is to separately review each party's position as to their respective claim or defense, and then bring the parties together on sufficient common grounds so that a settlement can be effected. The mediator does not make a decision as to who is right or who is wrong, nor is there any final order or award entered as a result of mediation, unless the parties reach a voluntary settlement. The mediator manages the process, helps the two sides prioritize their demands, and keeps negotiations on a realistic basis. The mediator may suggest compromises or terms but cannot impose them. Mediators are usually lawyers but can be business people or other professionals.



Comprehension Check

Define **mediation**.

Arbitration

In **arbitration**, the parties use an independent arbitrator to act in lieu of a judge or jury in resolving a dispute. Arbitration is usually provided for in a contract. In arbitration, both parties present their case to an impartial arbitrator. As with mediation, it is critically important that the arbitrator not only have the training necessary, but also be well schooled in the law and industry practices.

In most arbitrations, the normal courtroom evidence rules do not apply (Figure 18-2). This permits the parties to present their case and the arbitrator to hear the entire case. After the presentation of all of the evidence, the arbi-

trator announces a ruling and an award, which is binding on the parties. Arbitrators are often lawyers, retired judges, or may even be business people who have additional training in dispute resolution. They may be located through national and state professional associations.



Comprehension Check

Define **arbitration**.

Figure 18-2 Advantages of Arbitration

- May be faster and less expensive than litigation.
- The business relationship may continue while arbitration is occurring.
- An arbiter with special knowledge of the industry may be selected.
- Subject matter may remain confidential.

Extension Agreement

*Under an **extension plan**, the debtor proposes to pay creditors in full over a period of time.* An extension is, in effect, a deferral of payment of debts. The debtor remains in possession, continues to operate the business and temporarily buys on a cash basis. The creditors' committee acts in an advisory capacity only and does not assume active control of the business. An extension requires an optimistic prospect of future operations.

Establishing Controls

Creditors should make sure that adequate controls are instituted for the operation of the business and, in the event rehabilitation is not possible, over the liquidation of assets and disposition of the proceeds. This is done to provide reasonable assurance that assets are protected from improper use and to produce records from which reliable reports can be prepared.



Comprehension Check

What is an **extension agreement**?

Transfer of Stock

This is effective when the debtor is a corporation. The creditors' committee may have the stockholders transfer their stock certificates to the committee or to be held in escrow. If the extension plan is fully performed, the shares are returned. If not, the transfer becomes effective and the entire corporation becomes the property of the committee, to be liquidated for the benefit of creditors.

The committee may also receive and hold in escrow the written resignation of all officers and directors of the debtor corporation. The committee will thus be in a position to assume complete ownership and control if the debtor defaults under the plan.

Financial Controls

During the extension period, the committee may designate its accountant to monitor or, if necessary, supervise operations or have a representative countersign all checks and control expenditures.

Security

Under the extension plan, the debtor presumably will execute extension notes to the creditors, payable in installments. In addition, the creditors' committee may request or demand some form of security for payment such as a:

- Mortgage on the debtor's real estate, which is frequently owned by the debtor and spouse.
- Security interest in accounts, inventory and other assets of the debtor.
- Assignment of accounts receivable.
- Guarantee of the extension notes by a responsible third party acceptable to the committee.

A security interest in accounts, inventory and other personal property must be perfected under the Uniform Commercial Code (UCC).

New Trade Creditors

In order to obtain the cooperation of new trade creditors, a security interest under the UCC could be given to creditors with the old debt, and they in turn could subordinate that debt to the new trade creditors to give them a priority and encourage shipments to the debtor.

This type of arrangement has to be fully documented, and comply with the UCC with respect to the lien and the subordination. It is widely used in rehabilitation cases and gives a good measure of flexibility in working out problems.

Composition Agreement

A **composition agreement** is a *pro rata* settlement in which the debtor proposes to settle with creditors for less than the full amount owed. It is the quickest of all voluntary settlements.

How it works:

1. The debtor pays a uniform percentage of its obligations in cash to all its creditors, who accept the partial payment in full settlement of their claims.
2. The percentage depends upon what the debtor's assets are, what the debtor is able to pay and the amount that the creditors are able to procure in the negotiating process.
3. The debtor may obtain third-party loans or equity capital to make a settlement with creditors.

The Settlement Percentage

The most important criterion in determining the rate of settlement is what the dividend would be in bankruptcy proceedings. A *pro rata* voluntary settlement should be at least as high as the proceeds would be from bankruptcy proceedings. The costs of administration are low and the debtor avoids the stigma of bankruptcy. However, negotiating for a *pro rata* cash settlement is sometimes difficult. Some creditors will, as a matter of policy, accept extensions of time but not *pro rata* cash settlements.

If all creditors cannot agree to accept the *pro rata* cash settlement, it may be necessary to proceed to liquidate under Chapter 7 or 11 of the federal Bankruptcy Code, and creditors may realize a smaller percentage of their claims.

Creditors with Small Claims

Creditors with small claims frequently hold out for payment in full. It is often advisable to provide that payment to reduce the number of creditors and eliminate all small claims. Also, some creditors agreeing to reduce their claims to a specified amount may receive 100 percent of their claims, while a payment of 25 percent is paid to larger creditors.

Combination Settlement

A **combination settlement** is voluntary and contains both a *pro rata* cash payment and an extension of time. For example, the settlement may provide a cash payment of 20 percent immediately and three future installments of 5 percent each, or a total of 35 percent in full settlement. The installment payments, usually evidenced by notes, may be payable at three, six, nine or 12-month intervals. The disbursements are usually made by an adjustment bureau rather than by the debtor company. Because this method involves payments over time, control over the debtor's business and security for creditors during the extension period should be carefully provided.



Comprehension Check

What is a **combination settlement**?

VARIATION ON A THEME: SMALL CLAIMS IS A BREEZE

My first position as a credit manager was at a local seafood company in St. Louis. It was decided in the interest of saving money, that I would do all of my own small claims cases. After a few days of training, I began haunting the courthouses in St. Louis City and St. Louis County and observed several cases over the next few weeks. I watched and took a lot of notes. I tried to figure out what the judges did and didn't like. I began to get a feel of how the whole process worked.

There was a limousine company being sued by its customers because the driver had spun the tires on their lawn and damaged the landscape. The driver claimed that the passengers were rude and abusive, did damage to the limousine and told him to drive on their lawn in the first place since there was no place to turn around. The judge ended up splitting the fee between them, so no one really prevailed.

There was another case of payment due on the sale of a cockatoo. The judge asked if any payment had been received on the \$1,500 balance due.

"Yes your honor," was the plaintiff's answer. "Five hundred dollars and an iguana."

"Excuse me, what's an 'iguana'?"

"It's a big green lizard, your honor"

My first suit was against a restaurant on South Broadway. They owed us almost the limit of what you were allowed to sue for in that particular court. I filed all my papers and got a court date. I prepared spreadsheets and copies of delivery receipts, invoices and call records. I was a wreck. I paced. I practiced in the mirror. I fretted and had a slight melt down. "You can do this," was my mantra.

The court date finally arrived. I took great care in getting ready that morning. I took out my brand new navy blue suit, navy blue pumps and crisp white blouse. I even left my skirt hanging on the hook on the back of the bedroom door until the last minute so I wouldn't muss or wrinkle it. I did my hair and makeup and made a quick final inspection in the bureau mirror. I looked professional. I was ready.

I arrived at the court house just over two hours early. I had a briefcase full of every document ever created for any transaction having to do with that account. I had spent hours preparing. As I walked the three or so blocks from my car to the courthouse, I was thinking that it was pretty brisk out for a St. Louis spring morning and wished I had worn a coat. Wow, it was downright breezy. As I climbed the steps of the old courthouse, I glanced down to check my skirt for wrinkles and, to my horror, discovered that I had forgotten to put it on. There I was on the courthouse steps, briefcase in hand, in my brand new blue blazer, blue pumps, crisp white blouse—and my slip.

I raced back to my car and broke every speed record in the state of Missouri driving back to my house. I grabbed my skirt off the back of the door, threw it on, raced back to the courthouse and, though breathless, still arrived in time to have my case heard. The defendant arrived late, with little scraps of crumpled paper he called records, which he pulled in fistfuls from his pockets and placed on the table. We were awarded the judgment.

A few months later, after numerous attempts to collect the debt, I paid a visit to the restaurant during a very busy lunch hour, fully clothed I might add. I was accompanied by an extremely large and extremely patient deputy sheriff, who assisted me in enforcing my court order allowing me to seize the contents of the cash drawer. When the proprietor protested loudly, my companion gently took my arm and led me around behind him as if to shield me. He reached to his side, patted his gun and said, "Son, don't cause me to draw my weapon."

We collected what we were owed in full and went on our way. I still believe to this day that it will never be safe for me or anyone in my family to dine there or at any of the proprietor's other restaurants.

I discovered then that I loved working in credit. I loved everything about it. These days, though, when I walk out of my house and have the feeling that I'm forgetting something, I check for keys, purse and wallet. Most importantly, I check my attire in a full-length mirror instead of the one on my waist-high bureau.

Patti Guard-Younce

Administration Costs

Over and above the settlement amount to creditors, the plan must provide for payment of all administration costs. Administration costs include any expenses incurred by the creditors' committee, such as cost of counsel and accountant, court costs and out-of-pocket expenses of committee members. The costs of administration for voluntary settlements are usually lower than for formal proceedings.

Execution of the Settlement

When the creditors' committee has approved a plan it should, with the aid of counsel, prepare a notice to all creditors with details of the settlement plan recommending that creditors accept it. A form of acceptance should accompany the notice for signature by creditors and return to the committee. If the transaction is complicated, the notice should include a form of agreement drafted by the committee's counsel. Funds necessary for immediate payment to creditors are usually deposited by the debtor with the secretary of the creditors' committee. The secretary may also hold the outstanding notes on behalf of creditors.

Assignment for the Benefit of Creditors

While creditors' efforts are ordinarily directed toward rehabilitating the distressed debtor, some are too indebted and lacking in prospects to be turned around. In those cases, the debtor may be asked to execute a general assignment for the benefit of creditors, a liquidation technique by which the debtor goes out of business. There are two types of assignments: statutory assignment and common law assignment.

Statutory Assignment for the Benefit of Creditors

One of the vehicles to liquidate a failed or no longer viable business is an assignment for the benefit of creditors (ABC or Assignment). ABCs are a state law, rather than a federal law. This method of liquidating or transferring assets has the advantage of avoiding the unpredictability and expense of a Chapter 7 or a liquidating Chapter 11 of the Bankruptcy Code. It has long been popular in states such as Illinois and California and is regaining popularity in many other states such as Florida, Michigan, New Jersey, New York, Ohio, Pennsylvania and Texas.

An **assignment** is a transfer of the debtor's legal and equitable title to property to a trustee, with authority to liquidate the debtor's affairs and distribute proceeds equitably to creditors. In reality, an assignment is very similar to Chapter 7 liquidation under the Bankruptcy Code. The difference is that the bankruptcy court is not involved and the trustee does not report to the bankruptcy court. The trustee or assignee receives the debtor's assets which are to be liquidated for the benefit of all of the creditors of the debtor.

An assignment is subject to the state law of the state in which it is made. Many states do not have state statutes which regulate assignments, but depend on common law (case law) which has developed over the years. Other states, such as Florida and Indiana, have assignment statutes which proscribe how an ABC is conducted and may require court approval for the actions of the assignee. In spite of these differences, the concept remains the same; an assignment is a liquidation tool which places the assets with an independent fiduciary for benefit of all the creditors. Although there is not an automatic stay as under the Bankruptcy Code, the practical effect is that actions to reach the assets are stopped while the assignee acts to liquidate the assets. The creditor pursuing a judgment against the debtor may find that the assignee is willing to allow the judgment so long as the judgment creditor submits its claim as described below. The assignee may also defend against a claim if the plaintiff is seeking a judgment which is unjustified and not fair to other creditors.

Assignor and Assignee

The debtor company is the **assignor** who transfers its assets to the **assignee** who acts as a fiduciary to all of the creditors of the debtor company. The assignee and assignor enter into a contract by which the assignor agrees to liquidate the assets assigned for the benefit of the creditors of the assignor company. The assignee is generally an

unrelated individual who agrees to act in this fiduciary capacity and is experienced with liquidating assets. Upon acceptance of the assignment, all of the assets previously belonging to the assignor become the property of the assignee for the purpose of liquidation.

The assignee is generally chosen by the debtor and perhaps with the approval of the secured lender. They should be familiar with liquidations, sales of businesses and knowledgeable about the debtor's industry. A board of a debtor corporation may want to consider an assignment to a professional assignee to ensure that the board acting while in the zone of insolvency is using a professional and experienced individual who is able to be a true fiduciary to the creditors. Unlike a Chapter 7 Trustee who is randomly assigned from a panel of trustees, the assignee can be selected as knowledgeable with liquidations and the particular industry of the debtor.

Because the assignor is able to pick the professional assignee, the assignor and the prospective assignee are able to discuss what is likely to happen in the assignment, to negotiate the cost and payment of the assignee's expenses and determine whether the making of an assignment is worth pursuing. For example, if the assignor is to sell the debtor's business as a going-concern, the prospective assignee may want to make arrangements to retain certain valuable employees to run the business under the direction or administration of the prospective assignee. If the prospective assignee determines initially that there is not enough revenue expected during the assignment to support the ongoing business, the assignment may take another form such as liquidation. The advantage of an ABC over a Chapter 7 filing is that the parties can largely determine, prior to executing the assignment documents, what is going to happen during the assignment.

For the creditors of the assignor corporation, the assignment of assets to the professional assignee may be relief that the prior management is no longer in control.

Effect of the Assignment

The assignee accepts the assignment of the assignor property with all existing liens remaining in place. The assignee is likely to seek consent of the debtor's secured lenders prior to accepting the assigned assets. This ensures the assignment from being disrupted by a UCC or mortgage foreclosure. Many banks are happy to see an assignment and may in fact suggest an ABC as a reasonable way of liquidating a bad loan. The assignee will examine Uniform Commercial Code filings and other documents to determine who has valid and perfected liens on the assets.

The acceptance of the assignment by the assignee creates an estate which remains subject to all of the claims of creditors, both unsecured and secured. In states where the state court supervises assignments, the assignment contract will be filed with the court and supervision of the liquidation by the court begins. In common law states, the assignee may proceed to liquidate the property in a commercially reasonable fashion. In most cases, the assignee will advertise the sale or auction of the property in a manner which is economically realistic for the sale of that type of property. The assignee will also notify creditors of the debtor company as it is possible the creditors may know likely buyers or may be buyers themselves.

An ABC does not provide a discharge for the assignor debtor company, just as a Chapter 7 liquidation for a corporation does not either.

Cost of an ABC

The biggest advantages of an assignment over a Chapter 7 petition are the cost savings to the estate and the predictability of the outcome. Although less expensive than a Chapter 7 case, there are still significant costs such as the following for which payment must be provided:

- **Administrative rent.** This cost involves the cost of the assignee staying in the premises previously occupied by the assignor debtor. The assignee may be able to negotiate a reduction in rent or possibly a waiver if the premises are leased by the debtor's principal or related party.
- **Fees of assignee and other professionals.** The assignee is generally paid through a fee which is negotiated initially and is part of the assignment contract. The cash necessary to cover the costs of the assignment need to be there at the initiation of the ABC or there must be an agreement with the secured lender to advance monies to administer the estate

and preserve the assets. Fees may be determined as a percentage of the amount realized from the liquidation of the assets. The fees may also be fixed or capped by the assignment contract. In a state requiring that a court monitor the process, the court will approve the fees. In addition to the fees of the assignee, the assignee may require the assistance of attorneys, accountants or real estate brokers. Each of these professionals will need to receive payment for their services and this must come out of the estate assets, as well. The assignee, as a fiduciary to the creditors, has a duty to act efficiently and not incur fees needlessly.

Each assignment is different and the professionals required may differ depending on the type of business being liquidated and whether the business will continue to operate during the assignment. Because fees can be negotiated as part of the assignment contract, they can be predicted prior to being incurred. For example, if the debtor is aware of an interested buyer for the assets at the time of the assignment, the assignee may be able to negotiate the terms of a sale with the interested buyer and then use this buyer as the stalking horse to advertise a sale which may bring in other competitive bidders at an auction. If, however, no interested buyers have been identified, the assignee may have to spend time and expense attempting to locate buyers and drumming up interest for the assets. If the primary asset is liquidated, the assignee will be required to pay legal fees to continue the prosecution of the action. In many states, the costs of administration are considered a lien on the assets of the estate. In most circumstances the assignee will negotiate with the secured creditor the right to be paid, prior to even taking on the obligations of the assignment.

Steps of an Assignment

At the beginning of an assignment, the assignor is required to give the assignee a complete list of creditors and a list of all assets being assigned. Based upon this list, the assignee will send a letter to all creditors notifying them of the fact that the assignment has been made, providing information on the probable distribution that will be made to creditors and providing a claim form for each creditor to submit a claim to the assignee. After claim forms are returned, the assignee will determine the proper amount of each claim and inform the creditors if there are problems with the amount of a claim. After all the assets have been liquidated, the assignee will determine the distribution amounts based upon the priorities of claim type.

The assignee will generally inform the Internal Revenue Service that the assignment has been made and will file a notice with the local county and state recording offices. The assignee will also immediately determine whether there are any additional liens that have previously not been disclosed. The assignee will conduct Uniform Commercial Code searches and real estate lien searches, if real estate is involved, and to make sure that all creditors and interest holders receive notice of the ABC.

The assignee will take control of the assets, changing locks, taking over bank accounts, the debtor's books and records and generally securing all assets. The assignee may on limited occasions continue to operate the business to maintain going-concern value. This step is taken very cautiously and only where the business has sufficient funds to operate on a cash basis without incurring any additional debt. Most assignees will not operate a business because the cash is simply not sufficient.

Priority of Claims

Although state law may determine the priority of claims, where this is not determined, the assignees follow the priorities set forth in the Bankruptcy Code. Properly perfected secured claims will be paid prior to those of taxing authorities, wage claims and general unsecured claims. Certain states may alter this scheme if there are requirements under state laws that create a trust for certain categories of creditors such as employees, customer deposits or employee benefits. The assignee must also be aware of state reclamation laws which may provide rights to creditors delivering goods during the period of the assignor's insolvency.

Avoidance Actions

In a Chapter 7 case, the trustee will attempt to recover preference payments and fraudulent transfers. In an assignment, the assignee may pursue fraudulent transfers and preferences only as allowed under state law. State statutes in most states give the assignee the right to recover payments or transfers where the payments or transfers were made with the intent to defraud other creditors. Not all states offer the same right to recover payments which may simply be preferential. Even in states such as California, where a state statute does provide the right to recover preferential payments, a court decision has called this right into question outside a bankruptcy proceeding. If there are significant preferences to be recovered, the assignee may want to avoid taking on the assignment as a Chapter 7 case may be more appropriate.

Actions to Take When Notified of an ABC

There are many considerations to make upon receipt of a notice of an assignment for the benefit of creditors; some will depend on the industry or on the specifics of an individual situation.

Here are some questions to ask and considerations to consider:

1. Is the assignee qualified?

- Does the assignee have the type of experience that makes them qualified to act as a fiduciary for the creditors?
- Is the assignee disinterested?
- Is the assignee bonded?
- What is the relationship of the assignee to the assigning company, its principals and its secured lender?

2. Preferences

- If the debtor has been paying other creditors to the disadvantage of a creditor or other creditors, will the assignee be able to effectively pursue them for the distribution to other creditors?

3. Fraudulent Transfers

- Has the assignee examined the payments to insiders during the several years prior to the assignment?

4. Reclamation

- Were goods delivered during the last 10 days? State law reclamation rights remain in place.

5. Is a sale to insiders being proposed?

- If so, will the sale be tested in a commercially reasonable way so that the highest and best price for the assets can be obtained?
- If the sale appears not to be conducted in a public manner, why not?
- Is the sale being conducted to merely “cleanse the assets” so that the previous management can continue conducting business without debt?

6. Executory leases or contracts?

- If there are leases or contracts that should be rejected, it is possible that an assignment is not in the best interest of the estate and that the Bankruptcy Code may be the better vehicle?

If the checklist questions cannot be adequately answered and the assignee or their attorney will not provide satisfactory answers, the creditors should consider other remedies such as filing an involuntary petition to place the

debtor in a Chapter 7 case. The filing of an involuntary bankruptcy petition is a serious issue which should not be done without consulting an attorney, but it may be the best alternative. This is especially true where preferences will be left without recovery or where the sale of the assets does not appear to be commercially reasonable. If the assignee or the debtor is unwilling to provide information concerning the assignment, then there may be information that is being withheld and a bankruptcy proceeding may be a better method for liquidation with the full disclosure which would be provided to creditors.

On the other hand, if there are no significant preferences and the sale or liquidation of the assets appears to be commercially reasonable, an ABC may be the most efficient and cost-effective means of liquidating the assets for creditors. Even if there are preferences that may not be otherwise recovered without a bankruptcy, certain bankruptcy judges recognizing the professional assignee's expertise in the sale and liquidation of assets may abstain from administering the estate until after the sale. After that time, the bankruptcy court may adjudicate the case as well as the proceeds of the sale. If there are no preferences or other assets which can be better administered by the bankruptcy court, then the bankruptcy court will likely abstain from administering the estate. The assignment avoids the cost of filing motions with the bankruptcy court and seeking approval throughout the process. The assignee can object to claims informally and negotiate with individual creditors if necessary. The sale of assets can, if a known buyer has been identified, occur within three weeks or perhaps less if necessary. Thus, the value of the assets may be more readily available.

Assignments have become a more attractive vehicle for selling or liquidating companies. The increased cost of liquidating Chapter 11 cases and the Chapter 7 cases makes the use of professional and experienced assignees a good avenue for liquidating assets and creating a better return for creditors.



Comprehension Check

Describe the process of assignment for the benefit of creditors.

Common Law Assignment

The **common law assignment** is a device whereby a debtor transfers title to all assets to a third party, designated as assignee or trustee, with instructions to liquidate the assets and distribute the proceeds among creditors on a *pro rata* basis. The assignment may be made by a debtor without prior consultation with creditors, or it may be executed after meetings with creditors or a creditors' committee, when it becomes obvious that a voluntary settlement cannot be made. In the latter instance, an adjustment bureau is frequently appointed assignee.

Sale of Assets

The assignee proceeds to liquidate the assets, most frequently by public sale through a recognized auctioneer with adequate advertising to ensure competitive bidding. In rare instances, the assignee may sell at a private sale when a better price can be achieved. The assignee also takes steps to collect or sell accounts receivable.

Distribution

After deducting administration costs, the assignee distributes the proceeds from the sale of assets *pro rata* among all unsecured creditors. Because a common law assignment is not under the supervision or control of a court, administration costs are low and dividends to creditors may be correspondingly higher.

Acceptance

No creditor is obliged to accept a *pro rata* settlement. The creditor may refuse the settlement and file a claim in full. As a practical matter creditors usually accept it because the dividends are generally larger than those obtainable in bankruptcy, and their old claim may have little or no value unless the debtor subsequently acquires new assets.

Discharge from Obligations

In a common law assignment, the debtor does not receive a discharge from obligations. The debtor merely has its assets sold and the proceeds distributed among creditors. If, for example, the *pro rata* distribution is 35 percent, creditors retain their claims against the debtor for the balance of 65 percent. The principal users of this device are

corporations that are going out of business; a claim for the balance is immaterial since the corporation will be dissolved. Individual debtors seeking discharge from their obligations will couple the assignment with a proposal for settlement in full.

The credit professional should keep in mind that if dividend checks issued under a common law assignment are not accompanied by an agreement for discharge, no discharge is granted. The creditors may therefore cash the checks and receive their dividends without agreeing to discharge the debtor. Claims for the balance are retained.

The creditor must read the wording on the check to determine whether it can be cashed only by creditors accepting it in full settlement.

Receivership Proceedings (A Non-Bankruptcy, Court Proceeding)

Unlike compositions and assignments for the benefit of creditors, receivership proceedings are rarely voluntary. In most states, receivership proceedings can only be instituted by the commencement of any adversary-type proceeding. The receivership is instituted only after the court has made the determination that it is necessary and proper.

States may have different rules governing receivership administration, therefore careful attention should be paid by creditors to all communications received in the case so that they can maximize their return. If creditors feel that the receiver is not looking out for their best interests, it is possible to consider filing an involuntary bankruptcy case against the debtor to control the situation in either a Chapter 7 or 11.

Evaluating Settlement Offers

Traditionally, these offers are made and considered with little attention given to the time value of funds involved. A 100 percent settlement over two years or longer is usually deemed full recovery of a claim. Furthermore, in tax accounting, write-offs and recoveries are always depicted at face value, regardless of when they are made. In order to choose effectively, the credit executive should be familiar with the cost of capital and time value of funds concepts.

To establish the analysis, it is assumed that a creditor has been approached by a debtor in financial difficulty that wants to make an out-of-court settlement on a claim of \$100,000 that is now owing and past due. The regular series of collection efforts has been exhausted, and it does not appear likely that the debtor can pay all of the outstanding debt at this time. However, the creditor is satisfied that the customer proposing the settlement is an honest debtor. The analysis shows the best choice to yield the greatest financial recovery to the creditor.

One-Time Partial Payment

The simplest offer would be for the debtor to pay a percentage of the outstanding debt and have the creditor agree to forgive the rest. This would benefit the creditor as the longer a debt is outstanding, the less is realized over time because of the cost of carrying an accounts receivable. For example, the agreement may be for 20 percent payment and the balance to be written off. The creditor would receive 20 percent of the total receivable, or \$20,000. At the same time, the creditor writes off \$80,000 as a bad debt expense, assuming that the creditor keeps financial records on an accrual basis and originally recorded \$100,000 in sales and accounts receivable.

Present Value of Serial Payments

In the previous example, all of the actions take place in the present. Consequently, there is no need to consider the time value or the present value (PV) of funds when deciding whether to accept or decline the debtor's offer. However, when a schedule of serial payments is offered, a new set of variables must be considered. Because a dollar collected today is worth more than a dollar collected sometime in the future, the creditor should consider more than the face amount of any extended offer. Instead, the offer should be regarded as a stream of future payments to be discounted back to the present. The full offer is equal to the sum of the present values of all the payments.

They do not take into account nonfinancial factors, such as the desire to rehabilitate a particular customer or the need to make a vital penetration into a desirable market area. The consideration of nonfinancial factors may outweigh the potential financial recovery in any given instance.

Settlements That Benefit Debtors

Stretched out repayment schedules cause large losses in the present value of total recovery for the creditor, even if the debtor adheres to the schedule. Schedules that provide for small early payments and large payments made later in the plan also erode the creditor's present value of total funds recovered. The worst possible plan from the creditor's point of view is one that provides for a long period of repayment and also proposes installments that are small in the beginning and increase as time goes on.

Impact of the Cost of Capital

Potential losses in the present value of total funds recovered are directly related to the cost of capital of the creditor firm: they are lowest when cost of capital is low, and increase directly as the cost of capital increases. Furthermore, if the cost of capital tends to rise while a plan is in effect, the creditor will realize a lower maximum present value recovery than was projected by the earlier calculations.



Comprehension Check

What are the different ways to evaluate settlement offers?

Key Terms and Concepts.....



Alternative dispute resolution (ADR)	Extension plan, 18-6
Arbitration, 18-7	Insolvent, 18-2
Assignee, 18-11	Mediation, 18-7
Assignment, 18-11	Not liquid, 18-2
Assignment for the benefit of creditors (ABC),	Priority claim, 18-4
Assignor, 18-11	Public records, 18-2
Combination settlement, 18-9–18-10	Secured claim, 18-4
Common law assignment, 18-10	Voluntary settlement, 18-3
Composition agreement, 18-8	

Comprehension Check.....



1. List the warning signs of financial distress.
2. Explain the difference between **insolvency** and **non-liquidity**.
3. What may a **secured claim** consist of?
4. What may a **priority claim** consist of?
5. Why is unity important in voluntary settlements?
6. Explain the important requirements of a creditors' committee.
7. What items should be examined by the creditors' committee?
8. List the causes of financial distress.
9. Define **mediation**.
10. Define **arbitration**.
11. What is an **extension agreement**?
12. What is a **combination settlement**?
13. Describe the process of **assignment for the benefit of creditors**.
14. What are the different ways to evaluate settlement offers?

Summary.....



- There are many ways of handling insolvency or financially stressed debtors. Generally, one way is to keep the debtor in business and restore it to profitability, and the other is to put the debtor out of business, sell the assets and distribute the proceeds among creditors.
- There are many warnings signs that a business is financially distressed. A few include:
 - The debtor has stop taking advantage of available discounts
 - Tax or vendors liens are being filed against the debtor
 - Lawsuits are being filed against the debtor
- When a debtors liabilities exceed its debts it is deemed insolvent, and may not be liquid if the business cannot pay debts when they come due. It is imperative that credit professionals distinguish between a business that can be rehabilitated and one that should be liquidated.

- Voluntary settlements are simple and may be the best choice if the creditor is willing to take the temporary loss and if the debtor may emerge stable and continue as a customer.
- Voluntary claims are generally not advised unless secured claims and priority claims have already been taken care of by the debtor.
- **Voluntary claims** usually take one of the three forms:
 - **Extensions**
 - **Pro rata cash settlements**
 - **Combination settlements**
- The success of any credit dispute will be the full cooperation of all creditors and the debtor. If there is any preferential treatment, any creditor can rescind the settlement under the basis of fraud.
- During the first meeting of the creditors, a committee should be formed. It should select a chairman, secretary and counsel. The creditors should also ask an accountant be retained to make an independent examination of the debtor's books and records at the cost of the debtor. In these meetings, the creditor should obtain up-to-date objects of investigation, such as inventory and several years of tax returns. With this information, the cause of financial distress may be assessed.
- The debtor that remains outside of the formal bankruptcy statistically has a better chance of survival, which ultimately improves the chances that creditors get repaid. Questionable actions can include, but are not limited to, the following:
 - Sudden increases in purchases without corresponding increase in sales
 - Missing financial records
 - Excessively large salaries or expense accounts
- **Extension agreements** can be made, but are only advised if there is a good probability that operations will continue in the future. Creditors can institute controls to ensure the repayment of loans. Controls may include:
 - Transfer of stock
 - Financial controls: security and new trade creditors
- Each method of resolution includes payments of administration costs incurred by the creditors. **Methods of resolution** include:
 - **Alternative Dispute Resolution (ADR)**
 - **Composition agreement**
 - **Combination settlement**
- **Mediation** and **arbitration** are both methods of resolution. Mediation is non-binding, while an arbitrator acts in lieu of a judge. There are advantages to arbitration. One being, the arbiter may have special knowledge of the industry.
- The difference between a **composition agreement** and a **combination settlement** is that a combination settlement contains, not only a pro rata cash payment, but an extension of time.
- The two types of **assignments** are:
 - **Statutory assignment for the benefit of creditors (ABC)**
 - **Common law assignment**
- **ABCs** are state law, rather than federal law, and ABCs may be advantageous when liquidating assets by avoiding the unpredictability of a Chapter 7 or Chapter 11 bankruptcy proceeding. The biggest advantage may be the cost savings to the estate. Payment must be provided for the following:

- Administrative rent
- Fees of assignee and other professionals
- In a common law assignment, the assignee distributes the proceeds of the sale on a pro rata basis among the creditors. However, in a common law assignment, the debtor does not receive a discharge from obligations. Therefore, if the sale of assets is 35 percent of the claim, the debtor still owes the other 65 percent.
- When evaluating settlement offers, a creditor should pay attention to the time value of funds involved. A 100 percent settlement over two years or longer is usually deemed full recovery of a claim. Stretched out repayment schedules cause large losses in the present value for the creditor, even if the payments are made on time. These losses are directly related to the cost of capital at the time.

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