

An alternative to bankruptcy: the ABCs of ABCs

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In the second half of 2007 credit markets experienced a dramatic increase in defaults (see Table 1). However, somewhat paradoxically, this upswing in defaults did not cause a similar increase in corporate bankruptcy filings. Indeed, bankruptcy filings for 2007 remained at historic lows (see Table 2). Some commentators note that businesses are increasingly engaging in out-of-court work-outs; others complain that the bankruptcy process is too expensive and time consuming; while still others submit that the 2005 amendments to the Bankruptcy Code have made bankruptcy an even less attractive option for struggling debtors.

Table 1



Table 2

Public companies and assets filings for bankruptcy 1980 to 2007					
Year	Filings	Assets	Year	Filings	Assets
1980	62	1,671	1995	85	23,107
1981	74	4,703	1996	86	14,201
1982	84	9,103	1997	83	17,247
1983	89	12,523	1998	122	29,125
1984	121	6,530	1999	145	58,760
1985	149	5,831	2000	179	98,763
1986	149	13,033	2001	263	256,294
1987	112	41,503	2002	220	394,300
1988	122	43,488	2003	172	98,262
1989	135	71,371	2004	92	47,676
1990	115	82,781	2005	86	133,843
1991	123	93,624	2006	66	22,257
1992	91	64,226	2007	78	70,525
1993	86	18,745			
1994	70	8,337	Assets in the \$ billions		

Although all these factors are true, they only partly explain the recent dearth of corporate bankruptcy filings. Another part of the explanation is that debtors are increasingly taking advantage of an alternative to bankruptcy: the assignment for the benefit of creditors (ABC).

An ABC is a process governed by state law that provides for the orderly and controlled liquidation of a corporation's assets through a neutral, third-party administrator. Thus, it avoids the need to file for bankruptcy altogether. While similar to a Chapter 7 liquidation under the Bankruptcy Code, an ABC is often less time consuming, less expensive, less public and subject to less oversight.

This chapter explores the landscape of ABCs, explaining their history, comparing them to the formal bankruptcy process and assessing their strengths and weaknesses in an effort to understand their role better. In short, the ABC is a tool that debtors and creditors need to understand better as they become a more popular and important vehicle for business restructurings and liquidations.

History and structure of an ABC

As with most US law, ABCs trace their origin to common law. Prior to the promulgation of federal bankruptcy law, states created their own procedures for the liquidation of a troubled debtor. Even after Congress passed federal bankruptcy laws, these state law liquidation procedures remained an alternative to the bankruptcy liquidation process and have evolved into the current ABC regime. Today, the majority of states regulate ABCs by statute, as summarised by Table 3.

Some ABC statutes are mandatory, replacing common law assignments entirely. Other ABC statutes are permissive, allowing common law assignments to continue alongside the statutory counterpart. In a minority of jurisdictions (most notably California and Illinois), the ABC remains governed exclusively by common law.

A general ABC is initiated when the debtor executes an agreement – usually in the form of a contract or trust agreement – whereby the debtor assigns its right, title and interest in the debtor's assets to a neutral, third-party assignee in trust for the benefit of the debtor's creditors. The assignee then liquidates the assets and distributes the

proceeds, minus administrative costs, to creditors pursuant to the state law priority scheme. Under an ABC the assignee takes ownership of the assets as trustee and acts in a fiduciary capacity for the benefit of the debtor's creditors.

Once an assignment is commenced, unsecured creditors can no longer pursue their claims directly against the assets which are in the assignee's possession. Thus, as with a bankruptcy filing, the ABC process eliminates the "race to the courthouse" in which creditors of a troubled business often engage. Instead, those creditors must submit claims to the assignee which, if allowed, will give the creditor the right to share in any distribution of the proceeds from the assignee's liquidation of the debtor's assets. On the other hand, secured creditors will retain their security interest in the debtor's assets (if otherwise properly perfected and enforceable), and will generally have priority over all other claims, including in many cases the administrative claims associated with the assignment.

ABCs are not limited to liquidations. Just as in bankruptcy, an ABC can be used to facilitate a going-concern sale of the debtor's assets to a third party. However, an ABC does not provide for the reorganisation of a troubled business, as that relief is provided exclusively by Chapter 11 of the Bankruptcy Code. Furthermore, only corporate entities, not individuals or sole proprietors, are eligible to commence an ABC.

In many ways ABCs are similar to liquidation under Chapter 7 of the Bankruptcy Code. For example, both processes provide for a neutral third party to take control of the debtor's assets for the benefit of creditors. Similarly, both processes require creditors to submit a claim that, if allowed, will be eligible for *pro rata* distributions based on a similar priority scheme.

However, an ABC differs from the Bankruptcy Code in other significant ways, most notably the lack of a discharge for the debtor under an ABC, which is pre-empted by the federal government's exclusive power to enact a uniform bankruptcy law (eg, see *International Shoe Co v Pinkus* 278 US 261, 266 (1929)). Furthermore, the commencement of an ABC does not cause the stay of all other proceedings against the debtor, although the assignment of assets to the assignee has a similar impact in that it removes those assets from the reach of unsecured creditors. In many jurisdictions, the assignee lacks the power to avoid or recover preferential transfers.

Pre-emption of the ABC

When Congress first exercised its constitutional authority to enact a uniform bankruptcy law (Art I, US Const, §8(4)), it brought into question the continued viability of the ABC as an alternative state regime for business liquidation and financial restructuring (see *In re Klein* 14 Fed Cas 716, 718 (No 7865) (CCD Mo 1843)). While the ABC process persevered, the question of its pre-emption has repeatedly come up throughout its history. Most recently, the US Court of Appeals for the Ninth Circuit addressed the issue in *Sherwood Partners, Inc v Lycos, Inc* (394 F 3d 1198 (9th Cir 2005)). In *Sherwood* a divided court invalidated the California statute that gave an assignee the power to avoid preferential transfers in an ABC on the grounds that the statute was pre-empted by similar provisions in the Bankruptcy Code. In a much-discussed dissent, Judge Nelson recognised that "the reasoning by which the majority reaches this would pre-empt any number of state laws governing voluntary assignments for the benefit of creditors because those laws have the effect of altering the incentives of various affected parties to initiate bankruptcy proceedings... When the majority's reasoning is carried to its logical extension, it has the effect of pushing corporations threatened with insolvency from the less stigmatic, and less costly, voluntary assignment scheme into the world of federal bankruptcy."

Picking up on Judge Nelson's suggestion regarding the implications of the *Sherwood* decision, many commentators were quick to question the continued legitimacy of ABCs. However, courts that have revisited the pre-emption issue since *Sherwood* have either declined to follow *Sherwood* (see *APP Liquidating Co v Packaging Credit Co, LLC* 2006 US Dist LEXIS 60195 (ED Wisc 2006); *Haberbush v Charles & Dorothy Cummins Family Ltd P'ship* 139 Cal App 4th 1630 (2d Dist 2006)). Accordingly, while some pre-emption issues remain – most notably provisions relating to the discharge of debts – the continued viability of ABCs as a legitimate alternative to bankruptcy seems assured.

Advantages and disadvantages of an ABC

An ABC provides many benefits to a business debtor over a traditional Chapter 7 bankruptcy. Perhaps one of the greatest benefits is the debtor's ability to choose the assignee. Under Chapter 7 of the Bankruptcy Code, a trustee is randomly assigned by the bankruptcy court to take control of a debtor's estate on the petition date (see 11 USC §§ 701, 702(d)). On the other hand, the freedom to select the assignee in an ABC allows the debtor to choose someone with a particular expertise in the debtor's industry and work closely with that pre-selected assignee prior to the assignment to ensure an efficient and seamless liquidation or sale of the debtor's assets. The efficiencies achieved from avoiding the delay and uncertainty inherent to Chapter 7 result in lower administrative costs and a quicker resolution of the ABC for all parties involved. However, this freedom also allows for potential abuse as the assignee is hand picked and not subject to court oversight.

Another benefit of an ABC is the reduced regulation, oversight and public disclosure as compared to bankruptcy. An ABC is regulated by a relatively simple state statute or set of rules developed at common law, in contrast to the complex procedures and requirements of the Bankruptcy Code, which helps to expedite the process and reduce administrative costs. Similarly, in many jurisdictions ABCs do not require court involvement or public disclosure. This is beneficial for businesses and corporate officers that want to avoid publicity of their financial difficulties. For example, during the dot-com crisis in the early 2000s many financially troubled technology companies used ABCs to liquidate or sell their assets, in part because of the lack of public disclosure (eg, see David S Kupetz, "Note: Assignment for the Benefit of Creditors: Exit Vehicle of Choice for Many Dot-Com, Technology and Other Troubled Enterprises", 11 *J Bankr L & Prac* 71 (November/December 2001)). Had those technology companies filed for bankruptcy, many venture capital and private equity firms – which served as directors and officers for these companies – would have been required to report the bankruptcy in public filings with the Securities and Exchange Commission. Moreover, the various procedural requirements under the Bankruptcy Code for notice and court approval introduce uncertainty and complications that result in expense and delay which can be avoided in certain jurisdictions where an ABC does not require court involvement.

However, an ABC is not always a more advantageous solution for troubled enterprises looking for an alternative to bankruptcy; there are also various disadvantages. Foremost is the lack of a discharge for the debtor at the conclusion of the ABC. In general, the Bankruptcy Code provides for the discharge of most pre-petition debts at the conclusion of a bankruptcy proceeding (see 11 USC § 727 (individual discharge); 11 USC § 1141(d)(1) (A) (corporate discharge)). The power to discharge debts is the exclusive province of federal bankruptcy law and is thus unavailable in an ABC. Accordingly, at the conclusion of an ABC the debtor remains subject to the deficiency claims of its creditors.

Similarly, an ABC does not provide the assignee with the power to sell the debtor's assets free and clear from all liens and other interests or assume and assign executory contracts, as a debtor or trustee can do in bankruptcy (see 11 USC § 363(f) (providing for the sale of assets free and clear of liens); 11 USC § 365 (providing for the assumption or rejection of executory contracts and unexpired leases)). Furthermore, the priority scheme provided by state law is usually much less comprehensive than the priority scheme established by the Bankruptcy Code (see 11 USC § 507), which can make the claims-sorting process in an ABC more difficult. Finally, in jurisdictions where court involvement is not required to sell assets as a going concern through an ABC, the sale may be subject to collateral attack based on the value paid or another alleged sale flaw.

Thus, the use of an ABC as an alternative to bankruptcy provides many advantages, but has some drawbacks. Accordingly, a business considering whether to use an ABC or instead file for bankruptcy should analyse its specific situation within the framework of the ABC regime in its jurisdiction to determine whether it is indeed a beneficial alternative to bankruptcy.

Creditor rights under an ABC

So far this chapter has addressed the history and structure of an ABC and weighed the benefits against the disadvantages, all from the debtor's perspective. But what about the creditors in an ABC – do they have the right to contest a debtor's choice to commence an ABC?

The first answer lies within the Bankruptcy Code itself. Section 303 of the Bankruptcy Code provides that three or more creditors (unless the debtor has fewer than 12 creditors, in which case

one or more creditors) holding non-contingent, undisputed claims totalling \$13,400 or more may file an involuntary petition against a debtor in the bankruptcy court. The debtor then has 20 days in which to file a response, at which point the bankruptcy court will enter an order for relief against the debtor, if appropriate. If an order for relief is entered, the assignee must immediately stop the ABC process and turn over all the debtor's assets and provide accounts to the bankruptcy trustee for administration under the Bankruptcy Code (see 11 USC § 543(a)-(c)).

However, there are ways in which an assignee can challenge an involuntary petition for relief under the Bankruptcy Code. The most frequent and successful way is to request that the bankruptcy court abstain from taking jurisdiction and dismiss the case. Section 305 of the Bankruptcy Code provides that the court may dismiss a bankruptcy case if "the interests of creditors and the debtor would be better served by such a dismissal or suspension". Factors used by courts to determine whether to abstain under Section 305 include:

- avoidance of an unnecessary duplication of efforts;
- an available alternative for achieving an equitable distribution of assets;
- whether another insolvency proceeding has advanced to the point where it would be unduly costly and time consuming to restart the process in bankruptcy;
- whether federal bankruptcy proceedings are required to reach an equitable result;
- lack of prejudice to creditors from abstention and dismissal;
- the amount and complexity of assets to administer; and
- the motivation and purpose of the creditors seeking to invoke federal jurisdiction.

Thus, bankruptcy courts often abstain from taking jurisdiction over an involuntary petition when a legitimate, good-faith ABC has already been commenced. Indeed, the legislative history behind Section 305 reveals a preference for state law insolvency procedures (see HR Rep No 95-595 at 325 (1977); S Rep No 95-989 at 35-36 (1978), as reprinted in 1978 USCCAN 5963, 6281-82, 5787, 5820-22).

However, there are certain circumstances in which a bankruptcy court will nevertheless exercise jurisdiction over an involuntary petition and not abstain in the face of an ABC. The most common instance is when there are significant pre-

assignment transfers (ie, preferential payments) and the local jurisdiction does not provide the assignee with the power to avoid such transfers. In these situations, the federal bankruptcy process provides a superior method of liquidation because it allows the trustee to collect additional assets for the benefit of creditors. Accordingly, a bankruptcy court will likely exercise jurisdiction in such instances despite a request to abstain in order to ensure that creditors are not prejudiced.

Similarly, a bankruptcy court may refuse to abstain if the priority scheme under state law does not provide for an equitable distribution to creditors. In certain situations, even if a bankruptcy court accepts jurisdiction, the assignee may remain in possession and control of the debtor's assets if it better serves the interest of creditors, such as when the assignee possesses a unique industry expertise required to administer those assets effectively (see 11 USC § 543(d)(1)). Similarly, if an assignee took possession of the debtor's assets more than 120 days prior to the petition date, the assignee will remain in possession and control of the assets except as necessary to "prevent fraud or injustice" (see 11 USC § 543(d)(2)).

A bankruptcy court's decision to accept jurisdiction over a bankruptcy case where an ABC is already in place generally turns on the just and equitable treatment of creditors under each method. If on the whole all creditors are treated equally and fairly in an ABC, a bankruptcy court will be more likely to abstain from intervening at the request of a few creditors.

Final thoughts

As default rates continue to rise, businesses – especially in the small and middle markets – are increasingly turning to ABCs as an alternative to formal bankruptcy proceedings. However, an ABC is not a panacea for all enterprises looking to liquidate or sell their assets more quickly, more cheaply and with less publicity. Indeed, the Bankruptcy Code provides a superior regime for large, complex organisations in need of financial restructuring or liquidation. Nonetheless, alternatives to bankruptcy, such as the ABC, may provide a better solution for the troubled debtor.

Table 3

State	ABC statute
Arizona	Ariz Rev Stat §§44-1031—44-1047 (1999)
Arkansas	Ark Rev Stat §§16-117-401—16-117-407 (1999)
Colorado	Colo Rev Stat §§6-10-101—6-10-152 (1999)
Delaware	Del Code ann Tit 10, §§7381—7387 (1999)
Florida	Fla Stat Ch 727.101—727.116
Georgia	Ga Code ann §§18-2-42—18-2-59 (1999)
Indiana	Ind Code §§32-12-1-3—32-12-1-21 (1999)
Iowa	Iowa Code §§681.1—681.30 (1999)
Kentucky	KY Rev Stat ann §§379-010—379.170 (1999)
Massachusetts	Mass Gen Laws Ch 203, §§40-42 (2000)
Michigan	Mich Comp Laws §§27a.5201—27a.5261 (1999)
Minnesota	Minn Stat §577.01—577.10 (1999)
Mississippi	Miss Code ann §§85-1-1—85-1-19 (2000)
Missouri	Mo Rev Stat §§426.010—426.410 (1999)
Montana	Mont Code ann §§31-2-201—31-2-230 (1999)
New Hampshire	NH Rev Stat ann §§568-1—568.57 (1999)
New Jersey	NJ Stat ann §§2a:19-1—2a:19-49 (1999)
New Mexico	NM Stat ann §§56-9-1—56-9-55 (2000)
New York	NY Debt & Cred Law §§1-24 (1999)
North Carolina	NC Gen Stat §§23-1—23-48 (1999)
North Dakota	ND Cent Code §§32-26-01—32-26-06 (2000)
Ohio	Ohio Rev Code ann §§1313.01—1313.59 (1999)
Oklahoma	Okla Stat Tit 24, §§31—50 (1999)
Pennsylvania	39 PA Code §§1—215 (1999)
Rhode Island	RI Gen Laws §§10-4-1—10-4-13 (1999)
South Carolina	SC Code ann §§27-25-10—27-25-160 (1998)
South Dakota	SD codified laws §§54-9-1—54-9-22 (2000)
Tennessee	Tenn Code ann §§47-13-101—47-13-120 (1999)
Texas	Tex Bus & Com Code ann §§23.01—23.33 (2000)
Utah	Utah Code ann §§6-1-1—6-1-20 (1999)
Vermont	VT Stat ann §§2151—2158 (2000)
Virginia	VA Code ann §§55-156—55-167 (1999)
Washington	Wash Rev Code §§7.60.025 (2004)
West Virginia	W VA Code §§38-13-1—38-13-16 (1999)
Wisconsin	Wis Stat §§128.01—128.25 (1998)
District of Columbia	DC Code ann §§28-2101—28-2110 (1999)