ALTERNATIVES TO BANKRUPTCY
Article 9, ABC's, Receiverships and Other Alternatives
Panel Members

- Chief Judge Eric L. Frank, U.S. Bankruptcy Court (E.D. Pa.)
- Robert D. Katz, Executive Sounding Board Associates
- Jeffrey C. Hampton, Saul Ewing LLP
- Stephen B. Ravin, Saul Ewing LLP
- Ken Kaestner, PNC Business Credit
- David S. Lorry, Versa Capital Management, LLC

Moderator
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Bankruptcy
FILING FOR BANKRUPTCY...

- **Chapter 7** -- The chapter of the Bankruptcy Code providing for "liquidation" of a debtor’s nonexempt assets through the appointment of a trustee who gathers and sells the debtor's assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the Bankruptcy Code.

- **Chapter 11** – The chapter of the Bankruptcy Code providing for reorganization or liquidation, usually involving a corporation or partnership. A chapter 11 debtor usually proposes a plan of reorganization or liquidation.

- **Chapter 13** -- The chapter of the Bankruptcy Code providing for the adjustment of debts of an individual with regular income.
When is Bankruptcy Appropriate?

Considerations include:

- Burdensome labor contracts
- Unfunded pension liabilities
- Company size and number of creditors
- Ability of creditors to control restructuring process
- Strength and capabilities of management
- Unfavorable leases
- Lien perfection in question
- Legacy issues, including old trade debt from non-recurring vendors
- Consideration/appetite for converting debt to equity
Recent Trends in Bankruptcy Cases

- 363 Sales vs. Reorganizations
- Pre-packaged filings

Drivers of Trends in Bankruptcy Toward Alternatives:
- Code changes
- Costs
- Speed
- Patience
- Flexibility
- Creditor recoveries
- Interest in working through the Chapter 11 process
- Risk – Is your first loss the best loss?
The Benefits of Bankruptcy

**Advantages include:**

- The automatic stay
- Reduces operating expenditures and cash needed to fill cash “hole”
- Ability to sell assets free and clear of all liens, claims encumbrances and interests
- Ability to obtain additional financing and willingness of lenders to provide financing due to elevated administrative claim status
- May enable debtor to use cash collateral under certain conditions with or without lender consent
- Termination of unprofitable contracts and leases
- Cram down
- Existence of preference and fraudulent transfer statutes
- Enables business to be restructured or assets sold under court supervision to prevent potential decline in asset value
- Enables existing management and Board to oversee estate subject to court process and can influence/control estate causes of action
WHY BANKRUPTCY ISN’T ALWAYS THE BEST OPTION...

While there are many advantages to bankruptcy, it is not always the best option for a troubled company:

- Costs
- Timing
- Greater risks of litigation
- Asset values may diminish if there is a long sale process
- Uncertainty of outcome (i.e. whether the company will be able to reorganize)
- Reputation – poor perceptions of bankruptcy; loss of customers and goodwill
- Exclusivity deadlines
WHAT IS A STATE COURT RECEIVERSHIP?

- A court order whereby all of the property subject to a dispute in a legal action is placed under the dominion and control of an independent person (a “Receiver”) in order to secure the assets of the company.

- A Receiver may operate a company to maximize the value of the company’s assets, sell the company as a whole or sell part of the company and close unprofitable divisions.

- The appointment of a receiver is an extraordinary remedy.

**Why Might a Receiver be Appointed?**

- To preserve property during the time needed to prosecute a lawsuit
- To facilitate a transaction, conduct an orderly windup or act as a custodian
**Receiverships: Who is the Receiver**

- A Receiver is a neutral third party that acts on behalf of, and for the benefit of, all interested parties.

**Who Can Move to Appoint a Receiver?**
- Creditor
- Shareholders
- The corporation, pursuant to a board resolution

**Types of Receivers:**
- Federal Receivers – i.e. SEC, FTC, FDIC
- State Receivers
- Privately-Appointed Receivers
- Court-Appointed Receivers
 RECEIVERSHIPS: ADVANTAGES

 Advantages include:

• May be lower costs and quicker process
• Less stigma
• Remedy is flexible and can be tailored in scope by the court
• Management is replaced by the receiver
• A creditor may recommend a receiver
• Can be used against organizations that can’t be forced into involuntary bankruptcy (i.e. churches, non-profit organizations)
• Less reporting requirements and court hearings
• Allows for creativity
RECEIVERSHIPS: DISADVANTAGES

Disadvantages include:

- No automatic stay
- No opportunity to reorganize
- Trade creditors’ claims are rarely compensated
- The owners of the entity lose all control
- Actions against company may continue in other jurisdictions
- Limited ability to avoid preferences
- Limited power to assume or reject contracts
- Rules regarding professional fees are not as clear
- Receiver does not have same level of control and authority as a bankruptcy trustee
- Receiver not bound to distribution and priority schemes set forth in Bankruptcy Code
- Receivership does not prevent the debtor from filing for bankruptcy
RECEIVERSHIPS: WHEN ARE THEY APPROPRIATE?

Considerations include:

- Whether debtor’s business is a single asset real estate business
- Management issues – i.e. whether there has been fraud or gross mismanagement on the part of the debtor’s management
OUT OF COURT WORKOUTS
WHAT IS AN “OUT OF COURT WORKOUT?”

A consensual agreement made between the debtor and its creditors to resolve outstanding obligations and achieve financial stability outside a formal court proceeding.

Two Types:
- **Extension Agreement** – an agreement to extend the term of an initial agreement beyond its original end date.
- **Composition Agreement** – an agreement to extend repayment terms or accept less than full payment in exchange for a discharge of debts.

Workouts are typically less common due to difficulties in achieving consensual agreements under which all creditors are willing to accept less than full repayment.
OUT OF COURT WORKOUTS: ADVANTAGES

Advantages include:

- May be less expensive
- Generally less damage to reputation
- Reduced disruption to the debtor’s operations
- Reduced stress to managers, employees and creditors
- Allows for more flexibility and creativity
- Less reporting
- Ability to control process
Out of Court Workouts: Disadvantages

- Disadvantages include:

  - Potential for underperforming management to stay in place
  - No automatic stay
  - No ability to get rid of burdensome contracts or leases unless agreed to by appropriate parties
  - Requires the consent of creditors
  - Risk of holdouts -- No ability to bind non-consenting creditors to workout plan
  - Non-consenting creditors may demand information about the business or force the business into bankruptcy
WHEN IS AN OUT OF COURT WORKOUT APPROPRIATE?

Considerations include:

- Is the debtor seeking to preserve going concern value and maintain a viable company?
- Number of creditors and likelihood of consensus
- Number of employees
- Liquidity and adequacy of the debtor’s working capital financing
- Strength and credibility of management
- Debtor’s need for modified restrictive covenants or extended maturity
- Litigation less likely
- Market value of contracts and union agreements
ASSIGNMENTS FOR THE BENEFIT OF CREDITORS (ABC’s)
WHAT IS AN ABC?

- In an ABC, a troubled company (the “Assignor”) voluntarily assigns all legal and equitable title of, and custody and control over, its assets to an independent third party (the “Assignee”), who is selected to act as a fiduciary to the creditors of the business.

- The decision to undertake an assignment must be approved by equity.

- **What is the Role of the Assignee?**
  - An Assignee is similar to a chapter 7 bankruptcy trustee
  - Responsible for liquidating the assets of the business at maximum value and distributing proceeds to creditors
  - Appointed by the principals of the debtor, typically with consent of the secured lender to address possibility of assignment being disrupted by the filing of a UCC or mortgage disclosure.

- An Assignor may continue to operate the company for a short period of time if it is determined that this will increase recovery for creditors.

- If creditors are fully paid through the assignment, including the fees and costs of the Assignee, any residual interest or funds will be returned to the owners or shareholders of the business.
ABC’s by State:

- **Assignment laws vary by state:**
  - In some states, court supervision is required.
  - In other states, there is no formal court process unless the Assignee files a separate proceeding.

- **Statutory Provisions:** 33 states and the District of Columbia have statutory provisions governing ABC’s.
  - These states include: Delaware, Pennsylvania, New Jersey, New York, Florida, Massachusetts, Ohio, Texas and Virginia.
  - ABC’s in Delaware and Pennsylvania are relatively uncommon.

- **Common Law:** 17 states, including Illinois, in which assignments may be even more common, do not have statutory assignment provisions.
ABC’s: Advantages

Advantages of an ABC include:

- May be lower costs than bankruptcy
- Process is less formal and faster
- In many states, the Assignee maintains avoidance powers
- The Assignee is selected by the debtor’s management
- Limited operations can be continued to maximize remaining value
- Contractual obligations can be negotiated and resolved more efficiently
- Unsecured hold-out creditors are encouraged to participate in the ABC process since title to the debtor’s assets is transferred to the Assignee and there is little recourse against the debtor.
- Most ABC statutes do not provide a complete payment distribution scheme.
- Less likely that a sale will be challenged since the Assignee acts on behalf of all creditors.
ABC’s: DISADVANTAGES

Disadvantages of an ABC include:

- Assignee controls bank funding
- Assignee must answer to general creditors
- No ability to force transfers of leases and contracts without consent of contract party
- Costs
- No automatic stay
- Assignee obtains title to the assets subject to any liens (unless lien holder releases its lien)
- Federal claims have blanket first or second priority
- Can only provide for liquidation, not reorganization.
- Creditors not paid in full can still sue debtor for the deficiency
- An ABC is a default under most contracts
- If a bankruptcy is filed after the assignment and distribution take place, a trustee in bankruptcy may avoid the distribution as a preference.
- No cap on landlord claims
- Successor Liability
- An ABC constitutes grounds for entering an order for relief in an involuntary bankruptcy proceeding.
When is an ABC Appropriate?

Considerations include:

- Implications and impact of particular state/venue
- Existence of a comprehensive statutory scheme or precedent in the relevant state
- Desire to avoid negative publicity
- Desire to avoid potential liability for directors and management
- Number of and impact on employees
- Whether debtor seeks to transfer the assets of its business to an acquiring entity free of unsecured debt
- Whether asset recovery will be severely impacted by a costly and drawn out bankruptcy proceeding
ARTICLE 9 SALES

The “Friendly Foreclosure”
WHAT IS AN ARTICLE 9 SALE?

- An out of court process in which a secured lender acts on its lien encumbering the borrower’s personal property assets and effectuates a transfer of title to those assets.
  - The transfer may be to a third-party purchaser through a public or private disposition.
  - The transfer may be to the secured party itself, which will then retain the collateral in full or partial satisfaction of the underlying indebtedness.

- Notably, if a debtor defaults on an obligation to a secured creditor, the creditor may repossess and dispose of the collateral after notice and a hearing.
How might a secured creditor dispose of its collateral?

- The secured creditor may retain the collateral in full satisfaction of its claim.
- It may accept the collateral as a trade-in for a reduction in the obligation.
- The debtor may redeem the collateral by paying the secured party prior to any sale.
- The secured party may sell the collateral in a public or private sale.
**Article 9 Sales: Disposition of Proceeds**

- Proceeds of an Article 9 sale must be distributed in the order prescribed by UCC § 9-615(a):
  - The costs of repossession and sale, plus other administrative costs
  - The satisfaction of obligations secured by the collateral sold
  - The satisfaction of obligations secured by any subordinate security interests
  - The consignor of the collateral, upon demand

- If any deficiency remains, the secured party may sue to recover the deficiency amount.

- Any surplus is paid to the Debtor.
ARTICLE 9 SALES: ADVANTAGES

Advantages include:

- May be less expensive and less risk
- Faster and cheaper than bankruptcy process
- Possibility of negotiating terms that benefit borrower and/or guarantors
- All secured parties are notified in advance of the pending sale, which reduces the risk of later challenges.
- Elimination of junior liens and interests without judicial intervention
- If initiated by the most senior secured creditor, the sale of the debtor’s assets can wipe out the interests of all of the debtor’s other creditors.
- Better opportunity to attract synergistic buyers
- Creditors without an economic interest in the business have less opportunity to extract “holdup” concessions from the secured party during the sale.
ARTICLE 9 SALES: DISADVANTAGES

Disadvantages include:

- No established “safe harbor” process for foreclosures
- Obstacles may arise that slow down foreclosure process (i.e. litigation over “commercial reasonableness”)
- Lack of automatic stay
- Bank does not pass clear and free title to the extent that a bankruptcy court can pass clear and free title
- Successor Liability
- Difficulty of coordinating creditors and related constituencies in a less formalized process
Considerations include:

- Does the Debtor’s going concern value exceed its substantial hard-asset value but not its secured debt?
- Likelihood of a collateral deficiency
- Existence of complex debt structure
- Existence of interested investors
- Costs
- Speed
- Venue
- Fairness of the process
CASE STUDY NO. 1

- Small to Mid Market Company
- Losing Money, Limited to No liquidity
- Sale of Company unsuccessful
- Owners have lost interest
- No Owned Real Estate
- Debtor is not subject to significant additional claims (e.g. product liability)
- Secured Debt is greater than or equal to collateral value
CASE STUDY NO. 2

- Retail Company – 35 locations, 20 of which are leased
- Seasonal Business – garden/nursery centers, and time of year is October/November
- Debt Structure –
  - $60M Secured Revolver, Blanket Lien on all assets, minimal availability
  - $10M Term on Store Fixtures and Computer Equipment,
  - $20M Subordinated Loan secured by blanket second lien on all assets
- Trade Debt - $45M; Various Equipment Leases
- Company hired investment banker
- Secured Lender wants out of credit ASAP
- Owners/management refuse to sign personal guarantees and won’t contribute more equity
CASE STUDY NO. 3

- Manufacturing Company – default on secured loan
- Debt Structure - $35M Secured Revolver, Blanket Lien on all assets, $5M Term on Equipment, No Borrowing Availability
- Collateral Value - $25M
- Trade Debt - $10M; Various Equipment Leases
- Company is for sale, interested parties, no offers
- Lack of confidence in management
- Market is saturated with Company’s product
- Company requests $3M over-advance from Secured Lender to make upcoming payroll and pay for raw materials (Vendors all COD)
CONCLUSION: A COMPARISON OF ALTERNATIVES
## Comparison Chart: Part 1

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<th>Receivership</th>
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## Comparison Chart: Part 2

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| What is the Intended Result?             |                       | ✓   | ✓            | ✓         | ✓          |
| Liquidation                              |                       |     |              | ✓         |            |
| Reorganization                           | ✓                      |     | ✓            | ✓         |            |
QUESTIONS?