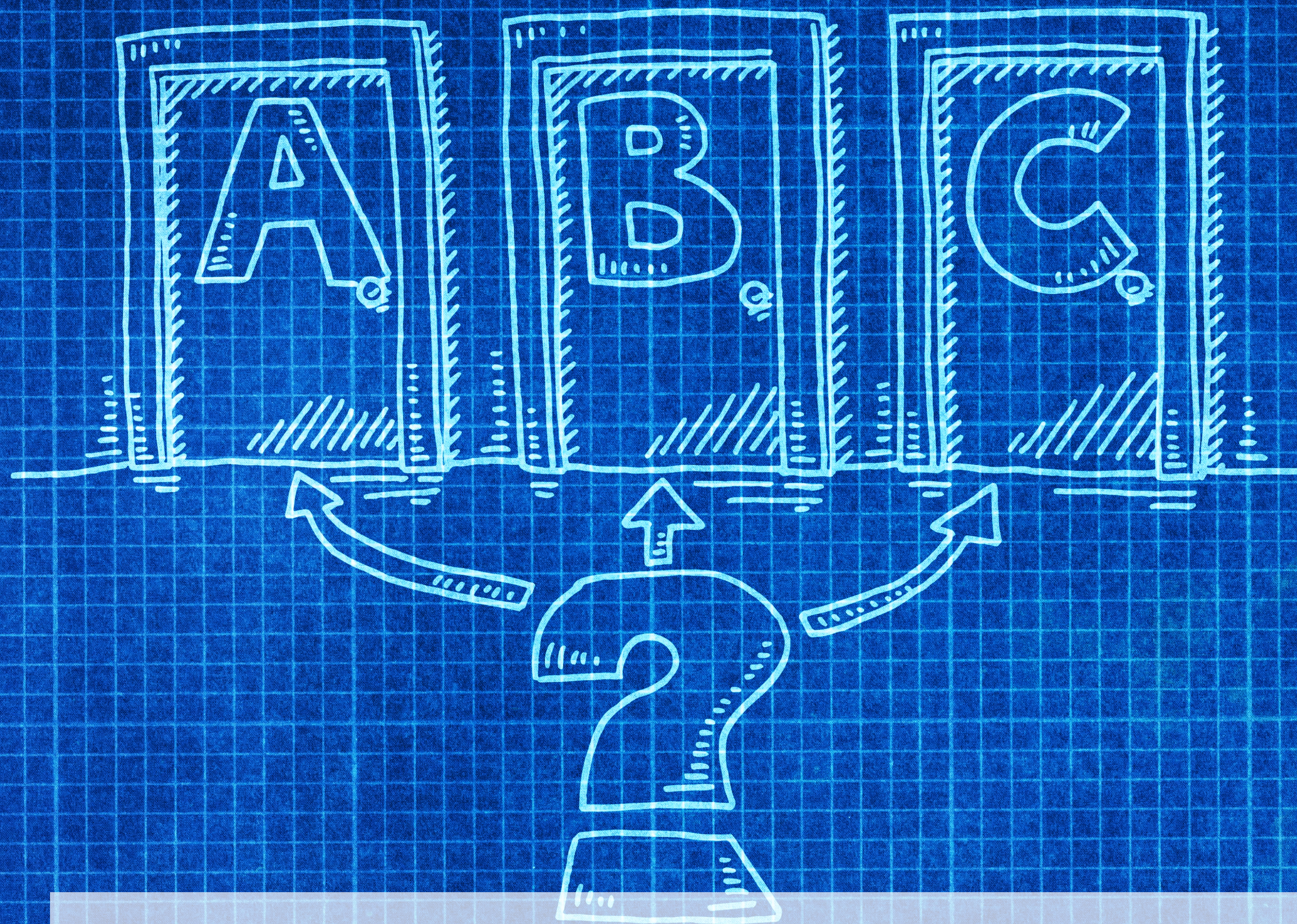
Practical Alternatives to a Bankruptcy Filing



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Once a distressed business and its advisors have concluded that an out-of-court restructuring will not satisfactorily resolve a debtor's financial difficulties, the company frequently begins planning to seek relief under the U.S. Bankruptcy Code. The code provides debtors and creditors with a detailed road map and important tools, including the automatic stay, free-and-clear asset sales, confirmation, and cram-down, for navigating a financial crisis. In the 30-plus years since the Bankruptcy Code was enacted, abundant case law has emerged on virtually all issues to provide management and counsel with a reasonable level of confidence and certainty as to process and outcome.

Bankruptcy, therefore, is an increasingly predictable tool. A bankruptcy case is not the only avenue considered by restructuring practitioners, however. In general, where (i) there is consensus among the constituencies as to the disposition of obligations to creditors, (ii) the debtor's balance sheet is reasonably straightforward, (iii) there are no major operational issues requiring redress, (iv) the priority of creditors is relatively uncontested, and (v) there are no statutory impediments to the distribution of assets, the debtor may be able to use an alternative proceeding to achieve its goals efficiently, cost-effectively, and with a reasonable level of certainty.

Three such alternative proceedings (out-of-court restructurings are assumed to be impossible or failed) are addressed in this article:

1. Foreclosure under Article 9 of the Uniform Commercial Code (UCC)
2. Assignments for the Benefit of Creditors (ABCs)
3. Receivership

To be sure, there are key differences between a bankruptcy case and these alternative proceedings. For example, foreclosures and ABCs may or may not be court-supervised, and a U.S. Bankruptcy Court is a more efficient forum to deal with sophisticated loan structures, multiple parties, and complex disputes.

After a comprehensive review of options and potential outcomes, if a debtor has concluded that (i) obligations to its creditors are due and certain, (ii) a secured creditor has a valid and legal claim to specified assets, (iii) there is little, if any, equity value remaining in the collateral after payment of all obligations to such creditor, (iv) there is no reasonable prospect for rehabilitation or restructuring as a going concern, and (v) the debtor can reach agreement in advance with its creditors with respect to a resolution of its financial obligations, the parties should consider alternative restructuring mechanisms in lieu of bankruptcy.

UCC Foreclosure

UCC Article 9 governs the creation and enforcement of security interests in personal property. A creditor that successfully negotiates with a borrower to securitize its loan must comply with the filing and notice provisions of Article 9 to perfect its interest in identified assets of the borrower. Secured creditors may avail themselves of the enforcement provisions of Article 9 when a debtor is in default and the creditor looks to recovery of its debt through the disposition of the assets identified as collateral in the UCC filings.

A creditor that forecloses against its collateral applies the value of that collateral against the borrower's outstanding debt obligations. A foreclosure addresses the disposition of specific assets and the potential resolution of a debtor's obligation to a secured creditor. It is a secured creditor remedy and does not provide the parties with a forum for restructuring the debtor's estate vis-à-vis multiple parties, nor does it offer the full complement of outcomes of a bankruptcy.

Before commencing a foreclosure action, a creditor should reconfirm that (i) the debtor is in default, (ii) the creditor has a valid security interest in specified assets, and (iii) its security interest was and remains properly perfected. In addition, the creditor should have a realistic idea of the value of the collateral and the importance of the collateral to the debtor's operations. The debtor is more likely to consent to foreclosure, assuming the creditor has a valid and perfected lien, if the value of the collateral is less than or equal to the outstanding obligations and is not critical to the debtor's business.

If the value of the collateral significantly exceeds the outstanding amount of debt and/or is integral to the day-to-day operations of the debtor's business, the foreclosure effort is more likely to be interrupted by a debtor's defensive actions, such as the filing of a voluntary bankruptcy, at some point during the foreclosure process. Other creditors also may impede the secured creditors' efforts if the perceived value of the collateral exceeds the amount of the secured debt.

A foreclosure action under Article 9 is properly effectuated only upon the successful undertaking of a number of procedures, such as (i) repossession of the collateral, (ii) reasonable notice of the proposed disposition of the collateral and a commercially reasonable sale, and (iii) disposition of the proceeds in accordance with the loan documents. While Article 9 foreclosure can be an efficient and economic process, a creditor should be aware of possible pitfalls, such as circumstances in which the foreclosure might give rise to successor liability issues for the creditor and the risk of a bankruptcy case commenced by the debtor, which would effectively stop the foreclosure process indefinitely, wasting the creditor's time, effort, and money.

ABCs

In an ABC, all of the debtor's rights, title, and interest in its assets are transferred to an independent assignee pursuant to a deed of assignment. An ABC is the functional equivalent of liquidation under the U.S. Bankruptcy Code. Unlike bankruptcy, however, an ABC does not discharge debt or, in most states, offer an automatic stay of unilateral creditor action.

In its simplest terms, an ABC is a liquidation proceeding under state law that is designed to efficiently distribute the debtor's assets with the debtor's cooperation, which has the concomitant effect of winding down the debtor's business in an informal manner. As such, an ABC may not be appropriate if the debtor's capital structure is complex or there are significant disputes among key parties.

An ABC can succeed only with the cooperation and consent of both the borrower and the secured creditor. Anything less would be both impractical and likely doomed to fail because the ABC transfers right, title, and interest to an assignee, and that right is subject to validly perfected liens. If the assignee has not obtained the secured creditor's consent to assign the creditor's collateral, the creditor could exercise its senior rights to obtain possession of its collateral from the assignee. Moreover, because there is generally no stay, there is nothing to stop a "race to the courthouse," which could interfere with the orderly distribution of assets in the ABC.

Receivership

Appointment of a receiver, upon application to a court by a creditor, disaffected shareholders, or the government, provides a useful third alternative to bankruptcy. Receivership is a means to address a borrower's failure to meet its debts as they become

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due, perform other legal obligations, or control a fraud-riddled enterprise. Cooperation between creditor and borrower, while beneficial, is not crucial to the success of this proceeding.

A receiver will generally be considered only after a related judicial action has already commenced. In general, the appointment of a receiver is seen as a drastic remedy justified only in extraordinary circumstances. A more generalized use of this proceeding occurs through the judicial enforcement of sophisticated real estate mortgage documents that permit the appointment of a receiver upon application of a mortgagee at or about the time of commencement of a foreclosure action.

A receiver is appointed by, and acts under the supervision of, the court and is generally empowered to take control over specified assets and act in accordance with applicable law and the instructions set forth in the relevant court order. A receiver's direction may be extremely broad and analogous to a liquidating trustee, or it can be rather narrow and limited to specified assets. The responsibilities of a receiver are not unlike those of a bankruptcy trustee or an assignee in an ABC.

Appointment of a receiver does not, by itself, invalidate all responsibilities of the borrower, however, and the appointment order should be clear and detailed with respect to the scope of authority of the receiver and the continuing roles of the various parties. Moreover, appointment of a receiver does not automatically stay litigation against the borrower, and, unless directorship and management have been totally displaced by the receiver by order of the court, appointment of a receiver does not displace the subject's corporate authority, nor preclude the subject from filing a bankruptcy case.

A bankruptcy usually displaces the receiver and places the subject back in possession as a matter of law. Also, it may become time-consuming and expensive if conflicting actions are being pursued by different parties in different jurisdictions at the same time.

Appointment of a receiver provides a judicial mechanism for the prompt transfer of property away from a debtor in instances when the court has been persuaded that the debtor's continued management over specified assets may result in waste, deterioration, or diminution of value. From the perspective of a secured lender or dissatisfied shareholder, therefore, an application for the appointment of a receiver may make sense. And, if provided with sole directorship and management over the troubled business to the exclusion of the prior board and officers, the receiver could file and maintain control of the debtor through a Chapter 11 bankruptcy case.

In less drastic situations, a debtor may be receptive to receivership as part of a broader agreement for the resolution of its obligations to creditors and shareholders. However, receivership is an extraordinary remedy that is appropriate only in limited situations.

Considering the Options

Once a debtor has concluded that it is not a candidate for a successful out-of-court restructuring, the generally preferred restructuring mechanism is a federal bankruptcy case. While the Bankruptcy Code provides a ready framework for reorganization or liquidation, it would behoove a debtor, its advisors, and key creditors to consider alternatives to bankruptcy, such as foreclosure under Article 9, liquidation in an ABC, or the appointment of a receiver. In certain circumstances, particularly when the parties are working cooperatively, these alternative proceedings may be more suitable, efficient, cost-effective, or result-oriented than a traditional bankruptcy case.