NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

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PICK YOUR POISON: ALTERNATIVES TO BUSINESS BANKRUPTCY

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I. Introduction

Financially distressed business debtors and their creditors have a variety of alternative options to bankruptcy. Whether a particular alternative is best for the parties depends on the situation. Some alternatives offer greater flexibility, others are less expensive, and still others provide more legal protection for debtor's management or for buyers of the debtor's assets. Each also has potentially different ramifications if the debtor later files for bankruptcy.

In general, both the management of a financially troubled business and creditors should seek to maximize value for eventual distribution to creditors. Although either a Chapter 7 or a Chapter 11 bankruptcy may be appropriate for achieving this goal, depending on the circumstances, a non-bankruptcy alternative may be better suited. The following is a non-exclusive list of factors relevant to choosing the right path. Because of the number of factors and number of available non-bankruptcy alternatives, helping your client pick its poison, or more optimistically its path, is not an exact science. The decision often comes down to picking between equally good choices based upon personal preference.

A. Liability Dangers for Officers and Directors

(1) Fiduciary Duties to Creditors When a Corporation is Approaching Insolvency.

Numerous cases assert a fiduciary duty of directors to creditors for corporations which are insolvent and, by some courts, for corporations "approaching insolvency." See, generally, e.g., Credit Lyonnais Bank Nederland, N.V. v. Path Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (in a case involving the liability of officers and directors in a failed leverage buy-out: "Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." A board of directors has "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."). See also, Weaver v. Kellog, 216 B.R. 563, 583-84 (Bankr.S.D.Tex. 1997) (construing Texas law to impose fiduciary obligations to creditors when the corporation is in the "vicinity of insolvency"); FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th.Cir. 1982), cert. denied, 461 U.S. 928 (1983). "[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors." In re Kingston Square Assoc., 214 B.R. 713, 735 (Bankr.S.D.N.Y. 1997).

Published cases finding liability for alleged mishandling of the affairs of an insolvent corporation which do not involve insider dealings are fairly rare. The scarcity of case law provides little clear guidance for officers and directors, increasing the risk of officer or director liability, especially where there is not a bankruptcy judge or other court approving major steps in the liquidation process.

Unsupervised auction. In one frequently cited older case, the court found the possibility of director liability where a state licensed auctioneer was hired to liquidate corporate assets rather than utilization of a more controlled process to maximize return to creditors. See New

York Credit Men's Adjustment Bureau v. Weiss, 110 N.E. 2d 397 (N.Y. 1953) (" If the assets in the trust fund for the creditors were actually improvidently wasted or depleted as a result of defendant's unilateral action the plaintiff is entitled to recover the amount of the loss").

Duty to file bankruptcy. Surprisingly little law exists addressing the issue of whether directors have a duty to cause a corporation to file a bankruptcy case or to do so in a timeframe designed to maximize assets. See however, In re Kingston Square Assoc., 214 B.R. at 713, 735 (Bankr.S.D.N.Y. 1997) (holding that an "independent" director of several "bankruptcy-proofed" entities whose consent was needed for a bankruptcy filing breached his fiduciary duty to creditors and limited partners by failing to ratify involuntary filings).

Reorganization versus liquidation. On the fringes of director liability concerns is the possibility of exposure for filing a Chapter 7 rather than a Chapter 11 case. Once equity is clearly "out of the money", management may have little incentive to maximize value through a controlled Chapter 11 liquidation, assignment for benefit of creditors, or true reorganization. Chapter 7 cases are judicially supervised and administration of the asset liquidation process is put in the hands of a court-appointed trustee. However, if a director's fiduciary duty is to maximize assets for creditors, could there be potential liability in a clear case where a timely going concern sale or managed liquidation other than through a Chapter 7 would bring a far greater return for unsecured creditors? See generally, Harvey R. Miller, Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations, 23 Seton Hall L. Rev. 1467, 1483 (1993).

(2) Specific Liability Dangers for Officers and Directors.

Even where business management is generally taking appropriate action to maximize asset value for creditors, whatever liquidation or reorganization path is chosen, officers and directors will need to avoid personal liability traps, including the following:

Federal Withholding Taxes. One of the most common personal liability landmines for management arises from failure to pay federal income tax and FICA withholding from employees wages. The "100% penalty" for "responsible persons" under 26 U.S.C. §6627(a) turns a corporate obligation into a personal one. Liability for failure to pay federal trust fund taxes is also non-dischargeable under 11 U.S.C. § 523 (a)(1).

State Sales and Withholding Taxes. Various state sales taxes are defined by state statute as a trust fund to be collected by sellers of goods and services. As with federal withholding taxes, "trust fund" sales tax statutes often include provisions for responsible officer liability if the tax is either not collected or not forwarded to the taxing authority. See, e.g., RCW 82.08.050 (Washington state sales tax). RCW 82.08.050 creates an express trust for sales taxes collected by a seller. Under this statute, a seller collects the tax and holds it in trust for the benefit of the State of Washington:

> RCW 82.08.050 Buyer to pay, seller to collect tax—Statement of tax—Exception Penalties. The tax hereby imposed shall be paid by the buyer to the seller, and each seller shall collect from the buyer the full amount of the tax payable in respect to

> each taxable sale. . . . The tax required by this chapter to be collected by the seller, shall be deemed to be held in trust by the seller until paid to the department, and any seller who appropriates or converts the tax collected to his or her own use or to any use other than the payment of the tax to the extent that the money required to be collected is not available for payment on the due date as prescribed in this chapter shall be guilty of a gross misdemeanor.

See also, Idaho Code 63-3035. Texas, Illinois, and other states also have trust fund provisions for sales taxes. These trust fund taxes also create a headache for secured creditors in that the taxing authorities will assert that the collected trust fund taxes are a statutory trust, not proceeds of collateral, and must be remitted to the taxing authority even if commingled with collateral proceeds. As an express trust, any taxes held by the seller are not property of the bankruptcy estate under 11 U.S.C. § 541(d). In re Begier, 496 U.S. 53, 62-67, 110 S.Ct. 2258, 2264-2267, 110 L.Ed.2d 46 (1990); In re Megafoods Stores, Inc., 163 F.3d 1063, 1067-1068 (9th Cir. 1998).

Environmental Laws. State and federal environmental laws create personal liability for "responsible persons." See 42 U.S.C. § 9696(c)(2)(1) (CERCLA) and equivalent state statutes. These laws can create almost literal liability landmines where business operations affect contaminated sites.

Employee Wages. Although less common than other liability dangers, officers and directors should be aware of other personal liability statutes for unpaid wages. Washington state has, for example, has a statute holding "officers, agents, and vice principals" liable for unpaid wages and imposing double damages. See RCW 49.52.050 and 49.52.070. Although the statute requires intentional action by the responsible person, the Washington Supreme Court has held that economic inability to fund payroll does not necessarily negate the intent element. Schilling v. Radio Holdings, Inc., 136 Wash 2d. 152 (1998). This interpretation of the statute has resulted in officers resigning failing companies rather than face potential liability under the statute when benefits, severance, deferred commissions, and other employee compensation debts may go unpaid.

Illegal Distributions to Shareholders. State corporation statutes typically prohibit distributions to shareholders without retention by the corporation of sufficient assets to pay creditors. Violation of these statutes may subject officers and directors to personal liability. See e.g., ORS 60.367; RCW 23B.06.400(2)(a)(b):

> No distribution may be made if, after giving it effect, (a) the corporation would not be able to pay its debts as they become due in the usual course of business; or (b) the corporation's total assets would be less than the sum of its total liabilities, plus, unless the articles of incorporation permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

B. Liability Dangers for Asset Purchasers

Besides liability traps for officers and managers, if the chosen path for dealing with insolvency involves sale of substantially all of the assets of the business, avoidance of liability for the purchaser becomes important. In general, purchasers will want assurance that the debtor, receiver, trustee, or general assignee selling assets (1) has title to the assets, (2) has corporate, judicial or other appropriate authority to convey the assets in question, and (3) can provide protection against liens encumbering the assets. Additionally, most going concern asset sales include potentially significant executory contracts. The ability to ensure that necessary contracts can be transferred despite anti-assignment clauses, *ipso facto* clauses, and undisclosed existing defaults may be extremely important to maximizing value.

Buyers will also typically desire comfort that the sale will not be attacked as a fraudulent transfer or under state common law successor liability theories. For example, in Washington, the purchaser of substantially all of a business's assets may be subject to successor liability if:

(A) the purchaser agrees, expressly or impliedly, to assume liabilities;
(B) the purchase is a de facto merger or consolidation;
(C) the transfer of assets is for fraudulent purpose of escaping liability; OR
(D) the purchaser is a mere continuation of seller.

Gall Landau Young Construction Company v. Hedreen, 63 Wn. App. 91, 96 (1991).

For a purchaser to have impliedly agreed to assume seller liabilities: its conduct and representations relied upon must show intent to assume seller's liabilities; it is not enough that purchaser voluntarily paid some of the debts of the old corporation without further manifestation of intent to pay all of its debts. Long v. Home Health Services, 43 Wn. App. 729, 734 (1986).

To be a "mere continuation" of seller, there must be:

(A) common identity of officers, directors, and stockholders of two corporations;
(B) the seller must obtain insufficient consideration for assets sold; and
(C) transfer must encompass all or substantially all of seller's assets.

Gall Landau Young Construction, 63 Wn. App. at 97.

One Washington court refused to impose successor liability on a creditor that took over an insolvent debtor to collect a bona fide debt pursuant to a valid, perfected security interest. Uni-Com N.W. v. Argus Publishing, 47 Wn. App. 787 (1987). The court did not address whether the first element, common identity of officers, directors, and stockholders, was present; the facts reveal, though, that the sole owner of the debtor was the majority owner of the creditor. *Id*. at 790. The court held that successor liability was precluded because the debtor received sufficient consideration -- forgiveness of a $2.1 million debt in exchange for assets valued at $200,000. The court distinguished other cases imposing successor liability on the grounds that the cases did not involve a creditor who (1) took over an insolvent debtor pursuant to a perfected security interest and (2) had substantial business interests in addition to those of the business assumed. The relevance of these two factors is unclear given that sufficient consideration should be enough in itself to preclude successor liability. *See also* Stoumbos v. Kilimnik, 988 F.2d 949, 962 (9th Cir. 1993) (noting that *Uni-Com N.W.* distinguished, on the above grounds, cases imposing successor liability).

A second court noted that successor liability should be imposed, where the sole owner of the creditor was the sole owner of the debtor, if the underlying debt forgiven was insufficient consideration for the transfer of assets. Stoumbos, 998 F.2d at 949. The court, without ruling on the sufficiency of consideration, said:

> [T]he 'consideration' [debtor] received consisted of fulfillment of its obligation to [creditor] through foreclosure and [creditor's] renunciation of a deficiency judgment. Arguably, had [creditor] had a good security interest in everything transferred there would have been adequate consideration. Any existing good will at the time [creditor] seized [debtor's] assets also would affect the adequacy of the consideration. [Creditor] to some extent 'paid' for the assets, but there was no payment for the employee base, customer relations and other intangible assets.

C. Other Factors to Consider

- Is reorganization with the existing entity intact possible or practical?
- Can current management stay in place and does it want to?
- If creditors will not be paid in full, is there a reasonable basis for equity holders to retain their ownership interest?
- Is there a secured creditor with a perfected, unavoidable blanket security interest?
- If assets are liquidated, what are the odds there will be proceeds in excess of secured debt?
- Are there significant avoidance actions or unperfected liens?
- Are there insider guarantees?
- Are there disputes as to asset ownership, liens, or claim priorities?
- If all of the assets are to be sold, will a buyer have concerns about future fraudulent transfer risks or whether assets can be sold free of liens?
- What time factors are relevant?
- Do the assets diminish in value once employees are terminated?
- What is the level of trust of creditors in current management?
- Are there out-of-state assets to liquidate?
- Are there numerous pending legal actions which would be disruptive to the liquidation or reorganization?
- How many creditors are there?
- Will the creditors be cooperative with a consensual approach?
- How likely and problematic would a subsequent involuntary bankruptcy be?

II. A Brief Synopsis of the Alternatives

This section provides a brief synopsis of six alternatives to bankruptcy and identifies some statutory and secondary authorities that serve as a starting point for deeper inquiry. Section III compares each alternative to bankruptcy, focusing particularly on flexibility, cost, and legal protection. Attachment 1 provides a list of cases discussing the treatment of receivers or other "custodians" in bankruptcy. Attachment 2 provides a comparison chart between receivership and bankruptcy. Attachment 3 is an introduction to Washington's new receivership statute. Attachment 4 is the new statute.[1]

A. <u>Corporate Dissolutions, Informal Liquidations, and Wind Downs</u>

A corporation may simply cease operations and liquidate its assets. Corporate dissolutions may occur either voluntarily or by administrative or judicial order. A creditor may bring an involuntary dissolution action if the corporation admits it is insolvent and the creditor has an unsatisfied judgment against it. Involuntary dissolution ends all corporate activity other than the winding up of corporate affairs. Most states, including Washington and Oregon, have corporate provisions like those found in the Model Corporations Act for corporate dissolution. Where there is no need for corporate judicial intervention to deal with creditors attempting to seize assets, disputes over liens or ownership, or to provide comfort to a buyer of corporate assets, a debtor-managed non-judicial liquidation of assets, followed by a corporate dissolution, may be appropriate.

Initial Steps. In order to commence dissolution proceedings, a corporation's board of directors must submit the question of dissolution to its shareholders. The board must either make a recommendation to its shareholders regarding the dissolution, or explain why it is unable to make such a recommendation. The board must then give the shareholders notice of a special meeting which will be held to consider the dissolution of the corporation. RCW 23B.14.020(4); ORS 60.627(4). Such notice must be given 20 to 60 days before the meeting. RCW 23B.07.050(1); ORS 60.214 (10 to 60 days in Oregon).

Under Washington law, unless the corporation's articles of incorporation specify a smaller amount, two-thirds of the shareholders entitled to vote on the dissolution must approve the proposal. Once shareholder approval is obtained, the corporation can then focus on the filing of the articles of dissolution.

Articles of Dissolution. At any time after obtaining shareholder approval, a corporation may file with the Secretary of State its articles of dissolution. Timing of the filing of the articles of dissolution is critical, as upon filing, the corporation is deemed dissolved. Thereafter, the only business a corporation can carry on is that that is appropriate to wind up and liquidate its business and affairs. RCW 23B.14.050(1); ORS 60.637.

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[1] As of March 10, 2004, SSB 6189 had been approved by the Washington legislature, but was awaiting Governor Locke's signature. The full bill as amended is also available at www.wsba.org/lawyers/groups/creditordebtor/default.htm.

The articles of dissolution must contain: (i) the name of the corporation; the date dissolution was authorized, (iii) a statement that shareholder approval was obtained, and (iv) a certificate of the Washington State Department of Revenue regarding tax clearance. This certificate basically states that the corporation is current in its taxes owed to the state. RCW 23B.14.030(1). See ORS 60.631 for Oregon equivalent.

Post Filing Actions. As described above, once the articles of dissolution are filed, the corporation is deemed dissolved and should then begin the process of paying off its bills (if any) and liquidating its assets (if any) for its shareholders. In liquidating the corporation, the board of directors is still subject to its corporate fiduciary duties under Washington law. In other words, a director who consents to a distribution to shareholders knowing that there are unpaid liabilities is personally liable to the extent of such improper distribution. RCW 23B.08.310(1); ORS 60.367.

The corporation must notify its known claimants of the dissolution. The corporation may begin the notification process at any time after the effectiveness of the dissolution. This notification must provide: (i) that the claim will be barred unless the claimant makes a written demand upon the corporation within at least 120 days after the notice., (ii) an address to where a claim may be sent, (iii) information required in the claim by claimant, and (iv) a statement that the claim is barred if not received by the deadline. RCW 23B.14.060(2); ORS 60.641(2).

If a claimant does not respond to the corporation's notice within the statutory 120-day period, its claim is barred. Sending the notice does not constitute an admission of liability; if the corporation sends the notice and receives a response that it disputes, it may so notify the claimant, and the claimant then would have 90 days to commence a lawsuit to enforce the claim. RCE 23B.14.060(3); ORS 60.641(3).

References: Washington's Business Corporations Act, ch. 23B.14 RCW; Oregon Private Corporations Act, ORS ch. 60; S. Landefeld, Washington Corporation Law & Practice §§ 11.4, 11.5 (1999).

B. Workouts and compositions

Workouts and compositions allow distressed debtors to restructure and repay their debt without necessarily terminating their business operations. The term "workout" is generally applied to any debt-related settlement arrangement. A composition is an agreement between the distressed debtor and a certain threshold number of creditors to accept a specified partial payment in exchange for full discharge of the debt. A similar agreement in which the creditor extends the time of payment rather than accepting a smaller sum in full payment is sometimes called an extension. This process avoids the formality and stigma of bankruptcy while leaving bankruptcy as an option in the future. Workouts and compositions, however, may be difficult to complete as a practical matter because often they require agreement by nearly all creditors.

A workout program should be structured to allow the debtor to continue operations by addressing key vendor questions including viability, management commitment to recovery, and the quality and quantity of claims against the debtor's assets. Creditors must believe the business is committed to a turnaround and a return to profitability, and management cannot appear to regain that profitability at the expense of creditors. It is equally important to analyze the claims against the debtor and the assets supporting those claims. A successful workout will involve an early and honest dialog between all parties.

Attempted compositions can be frustrated by uncooperative creditors and general creditor distrust of management. Compositions also generally require complete and accurate disclosure to creditors. Absent sufficient disclosure, creditors will lack confidence in the process and worry about giving a greater concession than necessary under the circumstances, or a greater concession than other creditors. Lack of candid disclosure can also jeopardize the enforceability of the creditor compromise if the creditor can show it relied on false representations.

<u>See</u>, <u>generally</u>, B. Blum, Oregon Debtor-Creditor Law § 19.2 (1985) (citing older case law on effect on non-disclosure).

C. <u>UCC Article 9 Foreclosures and Judicial Foreclosures and Sales</u>

Where management determines that the value of a business enterprise in its distressed condition does not exceed secured indebtedness, it may be appropriate for the debtor to cooperate with secured creditors in a transfer in lieu of foreclosure in a real property or UCC Article 9 foreclosure. In Washington, a properly conducted non-judicial real property foreclosure should not result in a fraudulent transfer liability for the purchaser. <u>See</u> RCW 19.40.031(transferee is deemed to have given reasonably equivalent value if the asset is acquired "pursuant to a regularly conducted, non-collusive foreclosure sale"). This may apply to a properly conducted non-judicial Article 9 sale. Moreover, where an Article 9 sale is not conducted in a commercially reasonable manner, the secured creditor foreclosing through the non-judicial sale process may have exposure.

Secured creditors may generally liquidate collateral after default. U.C.C. § 9-610 (RCW 62A.9A-610; ORS 79.0610). Article 9 of the Uniform Commercial Code regulates the conduct of the liquidation, notice requirements, and the creditor's duty to account for surplus funds. Both states strictly construe the requirements of Article 9 sales. The foreclosing secured creditor has the burden of proving that sale of collateral was accomplished in commercially reasonable manner. *Timms v. James*, 28 Wash.App. 76, 621 P.2d 798 (1980). Several factors determine whether a sale was commercially reasonable: the relationship of the price obtained to the recognized market price; the conformity of the sale to commercially accepted standards; the utilization of a recognized market in the sale; and the overall reasonableness of the means and methods of disposition under the circumstances. *Mount Vernon Dodge, Inc. v. Seattle-First Nat. Bank*, 18 Wash.App. 569, 570 P.2d 702 (1977).

Uniform Commercial Code ("UCC") Article 9 governs the sale of collateral by a secured party after default. Under Washington's version of the UCC:

> When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The

> *purchaser takes free of all such rights and interests* even though the secured party fails to comply with the requirements of this Part or of any judicial proceedings.
> (a) in the case of a public sale, if the purchaser has no knowledge of any defects in the sale and if he does not buy in collusion with the secured party, other bidders or the person conducting the sale….[2]

As the foreclosure at issue here was a public sale, the purchaser takes the purchased assets free and clear provided that (1) the purchaser does not have knowledge of any defects in the sale (such as improper notice); and (2) the purchaser does not act in collusion with the secured party, other bidders, or the person conducting the sale.

D. Successor Liability after Foreclosure

While the cited statute would seem to suggest that if the stated requirements are satisfied, the purchaser of assets from the foreclosure sale can never be held responsible for the liabilities of the party foreclosed against, courts have not necessarily interpreted the law that way.

In *Glynwed, Inc. v. Plastimatic, Inc.*,[3] the court considered whether a bank's sale of collateral under UCC 9-504 precluded any claim of successor liability. After a comprehensive review of other case law, the court concluded that "not only has [defendant] failed to cite any authority for its claim that the purchase of assets at a 9-504 sale ipso facto precludes a finding of successor liability; the relevant authorities actually suggest the opposite."[4] The court also opined that the substance of the transaction should be examined to determine the true intent of the parties.[5] As such, the use of 9-504 does not provide a safe harbor against successor liability claims.[6] Several other courts have agreed with the holding in *Glynwed* and have gone on to examine successor liability.[7]

References: RCW 62A.9A-601 et. seq.; ORS 79.0601 et. seq.; Revised Article 9 Deskbook by the Washington State Bar Association.

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[2] RCW 62A.9-504(4) (emphasis added). This language is from old UCC Article 9, which was effective in November 2000 when the sale took place. New UCC Article 9 became effective July 1, 2001. RCW 62A.9A-701.
[3] 869 F. Supp. 265, 273 (D.N.J. 1994).
[4] *Id*. at 275.
[5] *Id.*
[6] *Id*. at 274.
[7] *E.g. Quinn v. Thomas H. Lee Co.*, 61 F. Supp.2d 13, 21 (S.D.N.Y. 1999)(identifying the rule that a purchaser of assets ordinarily takes assets free and clear of any lien or interest, but going on to apply successor liability exceptions to that rule); *Equal Employment Opportunity Comm'n v. SWP, Inc.*, 153 F. Supp.2d 911, 924 (N.D. Ind. 2001)(holding that the mere fact that an asset transfer involved foreclosure does not insulate a successor where other facts show continuation); *Cf. G.P. Publications, Inc. v. Quebecor Printing—St. Paul, Inc.*, 481 S.E.2d 674, 682 (Ct. App. N.C. 1997)(allowing successor liability after a UCC 9-504 sale, but limiting the mere continuation test to inadequate consideration and common identity of ownership).

E. **Receiverships**

Receiverships are a judicial remedy used in different litigation settings. Both the Washington and Oregon statutes provide various grounds for appointment of receivers. Receivers are agents of the appointing court and are charged with doing specific tasks generally involving preservation and potentially liquidation of specified assets. Receiverships can be utilized merely to preserve the status quo pending litigation over control or disposition of the affected assets. For example, receiverships are commonly used in both Washington and Oregon in connection with real estate foreclosures to collect rents for the benefit of the secured creditor pending completion of a foreclosure. However, in most states, including Washington and Oregon, receiverships can be utilized for liquidation of substantially all of the assets of a debtor even where assets exceed the balance of secured claims. State law provides a process for notice to creditors and adjudication of claims and distribution of proceeds of assets sales conducted by the receiver with court approval. In Oregon, the process is established by common law, with some specifics provided by O.R.C.P. 80. In Washington, most of the powers of a receiver have previously been provided by common law with a modest level of statutory specificity. The 2004 Washington state legislature adopted substantial revisions to Chapter 7.60 RCW. These provisions codify and supplement common law to provide a relatively complete set of powers and procedures for liquidation of business assets, adjudication of claims, and distribution of proceeds.

As receivers duties are specified by court order and a receiver's protection from liability flows largely from operating within the powers provided by court order, specificity in the receivership appointment order, as supplemented during the evolution of the receivership case, is essential. The custom-made nature of the receiver's duties can be an advantage, providing cost savings over even a Chapter 7 bankruptcy. As with other non-bankruptcy alternatives, however, receiverships are susceptible to being interrupted and potentially replaced by a voluntary or involuntary bankruptcy proceeding.

The debtor or an affected creditor's motivation for initiating a bankruptcy may be minimized by selection of a respected and appropriately skilled receiver and by state law providing equivalent creditor and debtor protections to those found in the Bankruptcy Code. Differences remain, however, which may motivate parties to initiate a bankruptcy. For instance, even under Washington's new statute, receivers do not have the same avoidance action powers as a bankruptcy trustee. The Washington statute does not provide for the equivalent of a trustee's strong arm powers and the receiver's former ability to pursue preference claims as to corporate debtors has been eliminated. Also, although receivers can generally sell assets free and clear of liens and can assume or reject executory contracts, bankruptcy may be advantageous in forcing assignment of some contracts. For example, even under Washington's revised receivership statute, a receiver may not avoid the effect of an anti-assignment provision except by consent of the non-debtor party. Contracts in bankruptcy, in contrast, are generally allowed to be cured regardless of the existence of *ipso facto* clauses.

Receiverships are typically utilized as a creditor remedy and initiated in conjunction with creditor litigation. However, debtors can, in effect, participate in initiation of receivership actions in certain cases. For instance, a shareholder impasse or control dispute may be grounds for appointment of a receiver and such disputes are not uncommon in struggling companies. Moreover, nothing appears to prevent a debtor business entity from cooperating with or in fact inviting a creditor to seek appointment of a receiver.

References: ch. 7.60 RCW; ORCP 80; 1C Wash. Pract. Series § 83.8 (2004); B. Blum, Oregon Debtor-Creditor Law ch. 5 (1985).

F. Assignments for the Benefit of Creditors

Most states have some combination of statutory or common law allowing assignments for the benefit of creditors. In an assignment for the benefit of creditors ("ABC"), the debtor initiates a liquidation proceeding by transferring all of its assets to a fiduciary chosen to liquidate assets and distribute proceeds to creditors. Often these proceedings are non-judicial and have the advantage of potential speed and flexibility in the liquidation process, input by the debtor in choosing the assignee, and relative quickness and efficiency absent litigation complications.

ABCs have been used extensively in recent years in some states, especially California, in connection with the liquidation of failed technology businesses. They arguably have advantages over bankruptcy proceedings where a quick sale will preserve asset value and where continued employment of staff necessary for maintenance of software. Technology development is necessary to maximize asset value. With the cooperation of secured creditors, ABCs can be used to liquidate encumbered assets, but ABCs are perhaps more frequently used where the assets to be liquidated are largely unencumbered.

ABCs have not been used frequently in Washington or Oregon for many years. Previously, in both states, ABCs were not only established by statute but, until the 1920s or 1930s, included provisions for discharge of debtors and could be used even by individuals as an alternative to a Chapter 7 bankruptcy. State law discharge provisions were eventually overturned on federal supremacy grounds, in part leading to a general decline in usage of ABCs. Oregon's prior ABC statute was repealed. ABCs may still be used in Oregon under common law.

As part of Washington's new revamp of its receivership statute, the ABC provisions found in RCW 7.08 have been rewritten, in general providing for a specific form of creditor notice and providing assignees the ability to become receivers and utilize the provisions of the receivership statute where judicial intervention becomes necessary.

References: ch. 7.08 RCW; B. Blum, Oregon Debtor-Creditor Law § 19.3 (1985); Berman, G., General Assignments for the Benefit of Creditors, A Practical Guide, American Bankruptcy Institute (2000).

III. A Comparison of Each Alternative to Bankruptcy

The charts below compare non-bankruptcy alternatives with bankruptcies in three areas: cost, flexibility, and degree of legal protection to management and buyers.

Costs

	Cost	Time Required to Completion	Ability to Preserve Going Concern Value
Corporate Dissolution	• Relatively low costs if kept non-judicial	• Relatively short after completion of liquidation	• business ends but assets may have been sold previously
Assignments for Benefit of Creditors	• Relatively low if kept non-judicial	• Generally quicker than bankruptcy	• Can be used for going concern sale
Receiverships	• Can be lower cost than a Chapter 11 liquidation	• Generally quicker than bankruptcy	• Can be used for a going concern sale
Article 9 Foreclosures	• Low cost if non-judicial	• Quicker than bankruptcy sales	• Can be used for a going concern sale with debtor cooperation
Workouts	• Unclear depending on level of necessary disclosure • no court costs	• depends on negotiation	• business may continue on

Flexibility and Protection

	Who may initiate and how they may initiate	Pros and cons to bankruptcy	Legal risks compared
Corporate Dissolution	• debtor (voluntary) • state agency (involuntary) • courts (involuntary)	• Voluntary dissolution allows debtor to maintain control of process • debtor controls distribution of funds • no automatic stay or processes for dispute resolution on sales or claims	• no court blessing of management decisions • No D&O liability or successor liability protection other than from insurance
Assignments for Benefit of Creditors	• debtor assigns assets for benefit of creditors	• allows debtor to assign assets without court intervention • Article 9 priority over unperfected liens as in bankruptcy	• Typically no court approval • Dependant on creditor trust of process • No judicial blessing of transfer or resolution of disputes
Receiverships (Also see Attachment 1)	• Typically but not always initiated by creditors	• Fewer avoidance powers • *Ipso facto* and anti-assignment contract provision problems	• Susceptible to voluntary or involuntary bankruptcy petitions • Difficult to administer out of state encumbered assets
Article 9 Foreclosures	• creditor can repossess if no resistance by debtor • creditor can force sale • debtor corporation maximizes going concern value	• no avoidance powers • no protection for unsecured creditors	• unclear purchaser protection from successor liability • no judicial determination of contract transfer issues

Workouts and compositions	• debtor typically initiates proposal	• allows business to restructure and avoid stigma of bankruptcy • dependant on trust and cooperation of creditors, little ability to overcome holdouts	• risk of issues regarding inadequate disclosure to creditors

Attachment 1

BACKGROUND MATERIALS ON 11 U.S.C. § 543

The Transition Between Receivership and Bankruptcy

1. General Rule – Receiver to Cease Disbursements and Turn Over Property.

11 U.S.C. § 101(11) defines "custodian" as including a receiver of any property of the debtor and a receiver appointed to take charge of property of the debtor for the purpose of enforcing a lien or for general administration of property.

Under 11 U.S.C. § 543, a custodian shall cease making disbursements from property of the debtor or taking any action in administration of the property of the debtor except "as is necessary to preserve such property." § 543(a). The custodian shall also transfer property that is in the custodian's possession and file an accounting of any property of the debtor that came into the custodian's possession. § 543(b).

2. Allowance of Receiver's Fees Under § 543.

After notice and hearing, the Court shall "protect all entities to which a custodian has become obligated with respect to ..." the administered property and "provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such custodian." § 543(c). Section 543(c) provides for compensation to the Receiver and counsel for the Receiver as an administrative priority claim. See, generally, In re 245 Associates, LLC, 188 B.R. 743 (Bankr.S.D.N.Y. 1995) (discussing statute and legislative history). Section 543(c) also provides for the payment of post-petition services related to "winding up" the custodian's duties under § 543. In re 245 Associates, LLC, supra at 748; In re Posadas Assoc., 127 B.R. 281-82; In re Kenval Mktg. Corp., 84 B.R. 32, 34 (Bankr.E.D.Pa. 1988). "Accordingly, the superceded receiver need not obtain a retention order for the lawyer that assists him in performing these duties." In re 245 Associates, LLC, 188 B.R. at 748.

"Reasonable compensation for legal services for a superceded custodian is determined in accordance with the standards prescribed under the Bankruptcy Code, and 'based on the time, nature, the extent and the value of such services, and the cost of comparable services other than in a case under [the Bankruptcy Code].'" In re Snergy Properties, Inc., 130 B.R. 700, 705 (Bankr.S.D.N.Y. 1991).

As stated further by the court in Snergy Properties,

> "[m]oreover, the Bankruptcy Code contemplates that additional legal services will be incurred in preparing the custodian's application for payment in accordance with the standards required under the Code…. The receiver is entitled to compensation for properly incurred expenses notwithstanding that there was no previous authorization by this court because 11 U.S.C. §§ 543(c)(2) and 503(b)(3)(E) do not require such prior authorization."

In re Snergy Properties, Inc., 130 B.R. at 705. Thus, the receiver and counsel for the receiver are entitled to compensation for their prepetition services and expenses and compensation for post-petition services, including winding up the affairs of the receivership and applying to the court for compensation.

3. Leaving the custodian in possession - § 543(d).

11 U.S.C. § 543(d) provides:

(d) After notice and hearing, the bankruptcy court

(1) may excuse compliance with subsection (a), (b), or (c) of this section if the interests of creditors and, if the debtor is not insolvent, if equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property, and

(2) shall excuse compliance with subsections (a) and (b)(1) of this section if the custodian is an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, unless compliance with such subsections is necessary to prevent fraud or injustice.

Case law refers to Section 543(d) as reinforcing the general abstention provisions of 11 U.S.C. § 305, permitting the court to decline jurisdiction over a bankruptcy case in certain situations. The standard to be considered for whether a custodian is to remain in possession of property is the "interests of creditors." Cases discussing § 543(d)(1) identify various factors in determining the interests of creditors:

(1) the likelihood for a successful reorganization;

(2) whether the debtor will use the turned-over property for the benefit of creditors;

(3) whether there has been mismanagement by the debtor;

(4) whether the custodianship is part of a larger matter best handled in a forum other than the bankruptcy court; and

(5) whether the custodian has the power to best protect the interests of creditors.

3 Norton Bankr.L.&Prac. 2d, Section 52: 12.

The following is a sampling of cases discussing motions to allow the custodian to remain in possession.

In re Dill, 163 B.R. 221 (U.S.D.C. E.D.N.Y. 1994). A mortgagee of real property moved to have a state court receiver remain in possession because of prepetition mismanagement by the debtor, including depletion of security deposits, lack of certificates of occupancy, and substantial maintenance problems. The district court upheld the bankruptcy court's discretionary decision under § 543(d)(1) to allow the receiver to remain in possession. The court articulated the following factors:

> …(1) whether there will be sufficient income to fund a successful reorganization; (2) whether the debtor will use the turnover property for the benefit of the creditors; (3) whether there has been mismanagement by the debtor; (4) whether or not there are avoidance issues raised with respect to property retained by a receiver, because a receiver does not possess avoiding powers for the benefit of the estate; and (5) the fact that the bankruptcy automatic stay has deactivated the state court receivership action. 163 B.R. at 225, *citing, Constable Plaza Associates*, 125 B.R. at 103-04 (citing cases); *In re Northgate Terrace Apartments, Ltd.,* 117 B.R. 328, 332 (Bankr.S.D.Ohio 1990); *Powers Aero Marine Services*, 42 B.R. at 544-45; *In re CNN Realty Corp.*, 19 B.R. 526, (Bankr.S.D.N.Y. 1982).

163 B.R. at 225.

In re Lizeric Realty Corp., 188 B.R. 499 (Bankr.S.D.N.Y. 1995). Mortgagee purchased Chapter 11 debtor's sole asset at a postpetition foreclosure sale held without knowledge of the Chapter 11 filing. The mortgagee moved alternatively for dismissal of the bankruptcy, nunc pro tunc relief from stay, and to excuse turnover of the property by the state court receiver. The bankruptcy court denied the first two requests and granted the request under § 543(d) to allow the receiver to remain in possession. The court noted that:

> …[Movant] bears the burden of establishing cause under § 543(d) to excuse the receiver from the turnover provisions of § 543(b). *In re Northgate Terrace Apartments, Ltd.*, 117 B.R. 328, 332 (Bankr.S.D.Ohio 1990). Cause must be proved by the preponderance of the evidence. *See, e.g., In re S.E. Hornsby & Sons Sand & Gravel Co., Inc.*, 57 B.R. 909, 913 (Bankr.M.D.La. 1986) (preponderance of the evidence standard applied in turnover proceeding under § 543); *cf. Grogan v. Garner*, 498 U.S. 279, 286, 111 S.Ct. 654, 659, 112 L.Ed.2d 755 (1991) (noting that preponderance of evidence standard applies in most civil actions between private litigants).

188 B.R. at 506.

As in Dill, the court reviewed the Constable Plaza Associates factors and found that allowing the receiver to remain in possession was appropriate due to mismanagement of the debtor's building, including mortgage defaults, failure to pay taxes, forfeiture of the debtor's corporate charter, and nonresponsiveness to tenant complaints about maintenance.

In re Uno Broadcasting Corp., 167 B.R. 189 (Bankr.D.Az. 1994). Lender moved to dismiss bankruptcy as being filed in bad faith, for abstention, and to excuse turnover of the property by a federal court receiver. The court denied dismissal and abstention but granted the motion to excuse turnover by the receiver. The court referenced the Constable Plaza factors focusing on prepetition mismanagement by the debtor and competent management by the receiver. The court noted that the sole shareholder and person previously in charge of operations of the debtor was "unable to manage the business at this time, as he is in prison." 167 B.R. at 200. The court went on to discuss the role of the receiver. The court expressed the view that:

> … The receiver, as custodian excused from compliance with turnover in a bankruptcy case, now must have obligations and responsibilities to all creditors of the estate and, assuming solvency, to the equity security holders of the estate. The Receiver is now the functional equivalent of a trustee, although not having been appointed as such.

167 B.R. at 201.

The court went on to require the receiver to employ professionals after compliance with 11 U.S.C. § 327(a) and to provide regular management reports to the debtor on no less than a monthly basis.

In re KCC Fund V, Ltd., 96 B.R. 237 (Bankr.W.D.Mo. 1989). Debtor moved to compel turnover by the state court receiver of apartment complexes in compliance with 11 U.S.C. § 543. The court noted that

> … A mere showing that creditors will feel more comfortable with certain assets (such as cash or its equivalent) controlled by a third party rather than the debtor) is not sufficient. Creditors are usually not comfortable with the debtor in charge of any assets. In the mindset of each creditor, there is little question but what each debtor in bankruptcy suffers manifest defects in character, or they would not be in bankruptcy.

96 B.R. at 240.

However, the court noted that the three apartment complexes involved were "sadly neglected" and that the receiver had done a good job obtaining 100% occupancy where the debtor never had. The turnover motion was denied.

In re Metropolitan Adjustment Bureau, 22 B.R. 67 (9th.Cir.BAP 1982). Bankruptcy court ordered turnover by a state appointed conservator of assets of the debtor's collection agency businesses in a Chapter 11. The conservator had been appointed pursuant to a State of California disciplinary action to revoke the collection agency license of the debtors. The conservator argued that all funds were held in trust for the collection agency customers and were not property of the estate. The Bankruptcy Appellate Panel upheld the trial court's discretionary decision refusing to allow the conservator to stay in possession based in part on the fact that the conservator's concern is not for the creditors of the debtors as a whole, but for the customers of the collection agency. As there was a Chapter 11 trustee rather than a debtor in possession, prepetition mismanagement was irrelevant.

In re Sundance Corporation, 83 B.R. 746 (Bankr.D.Mont. 1988). Lender sought to excuse turnover by state court receiver of apple orchard located in Grant County, Washington. The creditor argued that the receiver was the equivalent of an assignee for the benefit of creditors, had been in possession longer than 120 days, and should be left in possession based on § 543(d)(2). The bankruptcy court rejected this argument noting the considerable differences between the two concepts. However, the court noted that the receiver was using the same foreman and consultant to manage the property as the debtor and that there were serious issues regarding whether the debtor could find a postpetition financing source. The court allowed the custodian to remain in possession pending rehearing of issues regarding the status of the state court receivership action and debtor's attempts to find postpetition financing.

In re Sundance Corporation, 84 B.R. 699 (Bankr.D.Mont. 1988). The bankruptcy court allowed change of venue to Washington where the major creditor and the apple orchard owned by the debtor were located.

In re Sundance Corporation, Inc., 149 B.R. 641 (Bankr.E.D.Wa. 1993). Pursuant to the debtor's Chapter 11 plan, the secured creditor purchased the orchard and related assets of the debtor. The custodian moved for allowance of its fees and costs and exoneration of its receivership bond. The major shareholder of the debtor and the secured creditor objected and sought a determination of liability of the receiver for environmental cleanup costs and damages relating to use of wooden stakes dipped with a mixture of pentachlorophenol and diesel fuel. Judge Rossmeissl determined that he had jurisdiction to review even the prepetition performance of the receiver in connection with allowance of compensation. The court analyzed the precedence for personal liability of a receiver and derivative judicial immunity. The court refused to grant summary judgment regarding the receiver's business decision to use the treated stakes as he could not determine on the factual record whether the receiver was simply acting in conformance with court order. The court noted Washington law indicating that:

> It is elementary law that a receiver is bound to exercise reasonable care and diligence in the management of his trust, and that he and his surety are responsible in damages to persons who suffer loss because of the failure of the receiver to perform his duty … The receiver cannot be held personally liable to the creditor for an honest mistake in the reasonable exercise of his judgment. He can be held liable only for careless or negligent conduct or for acts based on bad faith or fraud.

149 B.R. at 654, quoting Yakima Finance Corporation v. Thompson, 171 Wash. 309, 313, 316-317, 17 P.2d 908 (1933).

Judge Rossmeissl stated as follows:

> …When a receiver accepts appointment to its office, it undertakes duties to the court and to the estate. These duties are personal and supported by a surety. Derivative juridical immunity does not immunize a receiver for breach of these duties. Normally, a receiver must account personally to its appointing court for the performance of its duties and compliance with the appointing court's orders. However, to the extent that a receiver has merely performed actions which the court ordered it to take, a receiver should be immunized from liability to the estate. If a receiver's task is simply to implement the court's decisions and orders, derivative judicial immunity would be of great comfort to the [receiver].
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> … An order's immunizing power varies with the extent that a court is fully informed as to the nature of the options available for its consideration, and that notice and opportunity is given to interested parties to participate in the decision-making process. An order which is the result of such a process will provide much more protection than one which is the product of a receiver's mere suggestion. If the court and the interested parties are fully advised of the risks and options available to a receiver, given an opportunity to state their views on the proposed action, and the court's order then adopts the receiver's proposal, it would be difficult indeed to fault a receiver for following that order. (*Citation omitted.*)

149 B.R. at 654.