

By Leslie R. Horowitz and John A. Lapinski

Advising Distressed Businesses on an Alternative to Bankruptcy

Using a general assignment for the benefit of creditors may be a quick and effective solution

A general assignment for the benefit of creditors (ABC) is a useful device for liquidating the assets of financially distressed businesses.¹ ABCs are an expeditious and cost-effective alternative to bankruptcy.²

An ABC is a contract in which a troubled entity (the assignor) transfers legal and equitable title, as well as custody and control of its property, to a third party (the assignee) in trust, so that the assignee can apply the proceeds to the payment of the assignor's debts in the order of their legal priority.³ In California, statutory law makes the rights of creditors in an ABC similar to those in bankruptcy (for example, creditors are entitled to priority claims and assignees have the right to recover preferences). Many states have similar statutes, but California appears to have taken the lead in utilizing ABCs as an alternative to bankruptcy.⁴

By electing to use an ABC, a

party can avoid most of the costs and delays associated with the administrative procedures that govern bankruptcy court proceedings. Also, while a trustee in bankruptcy must seek court approval to sell assets, an assignee is not required to do so. Most failed entities prefer to shut down quietly and avoid the negative publicity and stigma of a public bankruptcy proceeding.⁵

The objective in using an ABC is to sell a company's assets in a way that will preserve as much of the going concern value as possible. This is accomplished by making an ABC and immediately thereafter selling the assets to a third party—identified by the assignor prior to making the ABC—so that the third party can

open for business the next day. The so-called prepackaged ABC operates in a similar fashion to bankruptcy without the associated delay and expense. The assignee sells the business assets in place as a turnkey operation. This can be particularly useful for a dot-com business to ensure that its Web site does not become frozen or unavailable even for a short period. If that

happens, the loss of visitors will be difficult to recoup once the Web site is up and running again.

In selling a business as a turnkey to a buyer, the assignee needs to assess what the distressed company has to sell. Dot-

coms seldom have hard assets. Instead, the assets typically consist of key employees, customer lists,⁶ and intangibles such as proprietary technology and other intellectual property, including trademarks, domain names, or URLs. These are frequently the totality of the company's assets.

An ABC is most productive when a prospective purchaser for the assets is identified prior to the acceptance of the assignment. Often the assignor is in a better position to locate a potential buyer and maximize the sale price due to the assignor's superior knowledge of the details of

the industry in which the distressed entity plays a part—and this knowledge includes the identification of competitors and others who may be interested in making an acquisition.

Planning and Executing an ABC

Once the decision is made to make an ABC, the assignor selects an assignee and the pre-assignment planning and negotiation begin. The assignor locates a potential buyer and negotiates the terms of an asset purchase-and-sale agreement. However, the proposed assignee, not the assignor, will ultimately be

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the seller. Once the terms of a purchase-and-sale agreement have been worked out, the assignor then approaches the proposed assignee to evaluate the potential sale transaction prior to accepting the ABC. The proposed assignee determines whether a fair or reasonable value is being paid for the assets. In assessing the transaction, the proposed assignee performs its own due diligence, which includes 1) an appraisal of the assignor's assets and 2) an analysis of whether any liens or security interests are asserted against the assignor and its assets. As part of its investigation, the proposed assignee should conduct a search of the records of the secretary of state for all secured creditor's filings, tax liens, and judgment liens. The proposed assignee should also undertake an intellectual property search with the U.S. Patent and Trademark Office to determine if any intellectual property exists under the name of the assignor as well as which creditors have a security interest in the intellectual property.⁷

Upon completion of its preliminary analysis, the proposed assignee advises the assignor whether it will take the ABC and whether it will close the purchase-and-sale transaction on the terms negotiated between the assignor and the buyer. Should the proposed assignee determine that it will proceed with the transaction, then the assignor and proposed assignee should move forward with the ABC and subsequent sale. If the assignee arrives at a contrary conclusion, the assignor will have to consider other options such as bankruptcy or negotiating a new purchase transaction.

An ABC becomes effective when both the assignor and the assignee execute a written contract of assignment and the assignee accepts the ABC. To facilitate the prearranged sale, the assignee, as the seller, should immediately proceed to close the transaction on the prearranged terms. In certain instances, the assignee may have to expose the transaction to competitive bidding, particularly if the assignor's insiders or affiliates will receive consulting or employment agreements or any other form of consideration in connection with the transaction. An assignee should only provide a warranty for legal title and the authority to sell the assets of the business. As a result, the buyer knowingly purchases the assets "as is." Most often, the buyer is getting a bargain for these assets and is willing to take risks in obtaining them at a reduced price. Of course, buyers should perform due diligence to minimize the risks.

An assignee generally will not operate a business. Just like a bankruptcy trustee, an assignee seeks to avoid administrative liability to the estate of the ABC. In a liquidation,

if unfinished goods must be completed to maximize a sale, an assignee may agree to complete any work in process, although this is the exception and not the rule.

California law contains myriad provisions that favor the use of an ABC as a means of selling business assets. For example, a sale through an ABC is an express exception to the bulk sale provisions of the California Commercial Code.⁸ The assignee is required to send out notice to the creditors of the acceptance of the ABC and provide an opportunity for the filing of claims.⁹ Still, the assignee has virtually the same authority as a bankruptcy trustee to pursue preference and fraudulent transfers.¹⁰

The assignee is a fiduciary¹¹ and thus should conduct an inventory and appraisal to establish the minimum value of the assets. This process not only protects creditors but will contribute to the establishment of a fair value for the buyer.

Secured Creditors

Another aspect of California law that favors the use of ABCs is the treatment of secured claims. Often the assignor's assets will not contain any net value in excess of the amount of secured claims. Since the assignee does not have the same statutory authority as a bankruptcy trustee to sell assets free and clear of liens,¹² secured creditors must consent to an ABC for it to be successful. The enactment of revised Article 9 of the Uniform Commercial Code, which became effective July 1, 2001,¹³ should encourage secured creditors to agree to and participate in an ABC to facilitate the sale of an assignor's assets. While the revised law could provide a trap for unwary secured creditors, they can avoid the risks inherent in the new provisions¹⁴ or other dangers involving foreclosure¹⁵ by permitting an assignee to liquidate their collateral.

Many sophisticated secured creditors actually encourage debtors to sell the assets of a distressed entity through an ABC, because the secured creditor feels more comfortable in knowing that an independent third party fiduciary will sell the assets for their maximum value in a professional manner. The secured creditors can avoid the uncertainty of foreclosing on assets when it is not known whether there will be significant bidders at a foreclosure sale. The selected assignee may have particular knowledge or contacts in the relevant industry that will assist in maximizing the value of the assets. Often secured lenders have little or no expertise in liquidating the collateral in which they have a security interest.

Before accepting the ABC, the assignee should negotiate with secured creditors for the subordination of security interests to the

assignee's fees and costs for administrating the assets. Generally, secured creditors will request that the assignee prepare a budget that should include, but not be limited to, the costs of 1) the sale, 2) taking inventory, 3) appraisal fees, 4) the search of the records of the secretary of state, and 5) attorney's fees.

An ABC, along with a prepackaged sale, can also help resolve certain issues concerning intellectual property licenses¹⁶—and the ABC can benefit both licensors and licensees.¹⁷ An ABC may provide the best option for licensors and licensees by insulating the licensees' assets from creditors while providing licensors with an opportunity to license a new entity free from the financial burdens of an "old licensee" (the assignor). A purchaser of the assets of the assignor will be in a good position to obtain a license from the licensor which, incidentally, will maximize the value of the old licensee's assets for the benefit of its creditors.

ABC procedures offer an additional benefit to the licensee's creditors and the licensor. If the brand name being licensed is that of a well known personality, such as a sports figure, the public often makes no distinction between a licensor and the licensee—and thus a licensee in financial trouble brings potential if not actual financial harm upon a licensor and causes substantial harm to the brand name and reputation of the personality. An ABC can prevent these difficulties.

Corporate Law Rules and Options

Certain rules of corporate governance may also favor the use of ABCs in some instances. When a distressed company's assets are being sold, corporate governance law comes into play most particularly in situations involving closely held or public foreign corporations qualified to do business in California. ABCs may be filed either in the corporation's state of incorporation or the state where the corporation has its principal place of business.¹⁸ When a corporation chooses to make an ABC in the state in which the corporation has its principal place of business, rather than the state of incorporation, the issue of which state's law is applicable must be addressed.¹⁹

A foreign corporation qualified to do business in California may be subject to certain provisions of the state Corporations Code.²⁰ In California, a corporation's board of directors must approve a sale or transfer of all the corporation's assets,²¹ and a corporation is not allowed to sell or otherwise dispose of the corporation's assets without shareholder consent.²² Shareholder consent is determined by a simple majority.²³

Delaware corporate law differs significantly from California law in several key areas

but may be utilized under certain circumstances to encourage the use of ABCs so that assets can be sold more efficiently. A significant difference between California and Delaware law governing ABCs concerns the disposition of corporate assets. Unlike the requirements of California's Corporations Code, Delaware law does not require shareholder consent to liquidate a corporation, and thus an ABC can be made and accepted without obtaining shareholder consent.²⁴ Under Delaware law, corporate directors are permitted to place a company in a liquidation proceeding, which allows ABCs to be used by public companies that could never realistically seek shareholder consent.²⁵

For closely held domestic corporations, the sale of assets to a new entity through an ABC may be an option to resolve situations that are frequently managed through a receivership. These circumstances include a corporate impasse in which either the board of directors or the shareholders cannot agree on how the corporation should be managed and an agreement cannot be reached between the disputing parties to buy the other's shares. Under California corporate law, shareholders can vote to break such an impasse by a mere 51 percent, which is the requirement for an approval of an ABC under California cor-

porate law. Any party, including a majority or minority shareholder, may form a new corporation and bid to buy the assets from the assignee for a turnkey operation. An ABC is a less expensive method than a receivership, which requires the filing of a lawsuit and motions for the appointment of a receiver and instructions to the receiver from the court.

Creditors of the assignor may file an involuntary bankruptcy after an ABC is made. However, this should not discourage the utilization of ABCs for selling assets. If an involuntary bankruptcy petition is filed during the first 120 days after an ABC has been made, the assignee may file a motion seeking an order requesting the bankruptcy court to abstain from exercising jurisdiction and to dismiss the case.²⁶ In California, the bankruptcy courts have long been overburdened with heavy case loads, and ABCs enjoy a high degree of acceptance as an alternative liquidation proceeding that is recognized and favored under the law by both state courts and bankruptcy courts. In addition, the assignee has standing to file a motion for abstention.²⁷

In a recent case, abstention was granted and the bankruptcy court dismissed an involuntary petition in which the assignor was a

public company formed under Delaware law but formerly operating in California.²⁸ The courts are more likely to grant an abstention motion when the assignee has been efficient in maximizing the value of the assets. The court may also require that the petitioning creditors bear the costs incurred by the debtor and the assignee in defending against an involuntary petition that is ultimately dismissed.²⁹ ■

¹ See Leslie R. Horowitz and John A. Lapinski, *Assignment for the Benefit of Creditors*, LOS ANGELES LAWYER, May 1993, at 21. Since 1993, the benefits of ABCs as an alternative to bankruptcy have expanded and the law regarding ABCs has been enhanced. ABCs should have particular utility for failing dot-coms or other technology businesses.

² 15 CAL. L. REVISION COMM'N ANN. REP. 2212 (1979); *Credit Managers Ass'n v. National Indep. Bus. Alliance*, 162 Cal. App. 3d 1166 (1984).

³ *Brainard v. Fitzgerald*, 3 Cal. 2d 157, 162-63 (1935); *Fenton v. Edwards & Johnson*, 126 Cal. 43, 46, 47 (1899).

⁴ The American Bankruptcy Institute (ABI) recently drafted a manual on assignments in an attempt to create national uniform procedures. ABI, *GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: A PRACTICAL GUIDE* (Dec. 2000).

⁵ Joanna Glaser, *Dot Coms Do Bankruptcy Faster*, *Wired News*, at <http://www.wired.com> (Sept. 28, 2000).

⁶ An attempt to sell customer lists in a bankruptcy may involve serious delays because courts, faced with the issue of privacy rights, may be inhibited from permit-



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ting a sale of a list without customer notification. Note, *When You Can't Sell to Your Customers, Try Selling Your Customers (but Not under the Bankruptcy Code)*, 8 AM. BANKR. INST. L. REV. 395 (2000).

⁷ For more information on obtaining security interests in intellectual property and dot-coms in particular, see Chertok & Agin, *Restart.com: Identifying, Securing and Maximizing the Liquidation Value of Cyber-Assets in Bankruptcy Proceedings*, 8 AM. BANKR. INST. L. REV. 255 (2000).

⁸ COM. CODE §6103.

⁹ CODE CIV. PROC. §1802.

¹⁰ CODE CIV. PROC. §1800; CIV. CODE §3439.01(c).

¹¹ *Brainard v. Fitzgerald*, 3 Cal. 2d 157, 163 (1935) ("It [the assignment] is supported by a consideration (the indebtedness to the creditors), and vested title in the assignee as trustee for all the creditors.").

¹² 11 U.S.C. §363.

¹³ The revisions to U.C.C. art. 9 include new requirements for the disposition of collateral by secured creditors, which may have an impact in influencing a secured creditor to agree to an ABC to dispose of its collateral. Among the changes is a longer notice period before foreclosure sales can be held. Former law required a 5-day notice period; under the revised art. 9, the safe harbor for notice is a minimum of 10 days. U.C.C. §9-612(b). Furthermore, the new provisions concerning the form of notice to the debtor and holders of junior security interests are more specific and require exact compliance to avoid penalties and loss of deficiency rights. A new section requires secured creditors in some instances to improve the collateral if commercially reasonable sales would subjectively require that the collateral be sold only after cleaning or repairing. Official Comment 3 and U.C.C. §9-611. Revised art. 9 provides for the inclusion of warranties in favor of a purchaser at a foreclosure sale unless the warranties are disclaimed by appropriate notice. U.C.C. §9-610(e) and (f). Sales by secured creditors under new art. 9 may be challenged on the grounds of commercial reasonableness regarding compliance with the procedure on the disposition of collateral as well as the price received at the sale. Official Comment 10. A secured creditor may conduct a sale in compliance with new art. 9 but may still be subject to an adjustment by a court to the deficiency calculation.

¹⁴ Assignees generally are experienced in liquidations and are required to comply with commercially reasonable standards in such efforts. *Sweet v. Markwart*, 158 Cal. App. 2d 700, 707 (1958); see also *Security Pacific Nat'l Bank v. Geernaert*, 199 Cal. App. 3d 1425 (1988).

¹⁵ See Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. §§9601-75; EPA Rule 40, C.F.R. §300.1100 (1990).

¹⁶ Recent cases in the Ninth Circuit as well as other circuits have made it more difficult for intellectual property assets to be assumed and assigned. Thus assignees, as a practical matter, must negotiate with a licensor creditor in advance of the assignment to permit a sale or license to a buyer. See *Perlman v. Catapult Entm't, Inc.*, 165 F. 3d 747 (9th Cir. 1999) (ruling that the Bankruptcy Code cannot be used to permit debtor licensees of a patent to assume executory contracts that are nonexclusive license agreements without the licensor's explicit consent). The Ninth Circuit reasoned that its position is mandated by certain language in BANKR. CODE §365(c): The debtor can assume or assign its rights under a patent license to a third party only within the confines of applicable state or federal law, or with the licensor's consent. *Catapult* will have a long-range negative impact on the ability of a holder of a nonexclusive intellectual property license, under the license agreement, to successfully utilize the provisions of BANKR. CODE ch. 11.

The impact of Catapult and the breadth of its application are unclear. Certainly, with regard to licensees of nonexclusive patents, the court has spoken. It has been argued that Catapult extends to nonexclusive licensees of rights obtained by contract. If this is so, the usual automatic reaction of troubled dot-com companies utilizing nonexclusive licenses to file for bankruptcy protection in an effort to sell or transfer their licenses may be misplaced and an unfortunate miscalculation regarding whether the licenses can be assumed or assigned under BANKR. CODE §365.

See also In re West Elec., Inc., 852 F.2d 79 (3d Cir. 1988).

¹⁷ Another distinction between ABCs and bankruptcy is the court's authority to permit a debtor to assume and assign executory contracts and unexpired leases. Clearly, this power does not exist under California assignment law nor could it without violating the U.S. Constitution. U.S. CONST. art. I, §8; 11 U.S.C. §365(a) and (f); *Worthington v. General Motors Corp.*, 113 F.3d 1029 (9th Cir. 1997).

¹⁸ CODE CIV. PROC. §493.020; *Danjas S.A. v. Pathe Communications Corp.*, 979 F.2d 772 (9th Cir. 1992).

¹⁹ In California, a domestic corporation making an ABC must comply with CORP. CODE §1001: When a corporation "...otherwise dispose(s) of all or substantially all of its assets...approval by the outstanding shares..." is necessary. CORP. CODE §152 provides that a simple majority of shares constitutes approval.

²⁰ A foreign corporation is subject to these requirements of the California Corporations Code if the average of the property factor, the payroll factor, and the sales factor is more than 50 percent during the corporation's latest full income year (as defined in REV. & TAX. CODE §§25129, 25132, and 25134) and if more than half of its outstanding voting securities are held of record by persons having addresses in California. CORP. CODE §2115(a) and (b).

²¹ CORP. CODE §1001(a)(1) (§1001 is incorporated by CORP. CODE §2115(b)).

²² CORP. CODE §1001(a)(2).

²³ CORP. CODE §152.

²⁴ *See* *Bailey v. Kennedy*, 1835 WL 324 (Del. Ch. 1835); *see also* *Stockley v. Horsey*, 1874 WL 1979 (Del. Ch. 1974); *Asmussen v. Quaker City Corp.*, 156 A. 180 (Del. Ch. 1931).

²⁵ Delaware statute and case law is silent on the requirement of shareholder consent and would likely follow common law doctrine. Delaware General Corporations Law (DGCL) §271(a) provides that a corporation may not sell or exchange all its assets without shareholder approval. It appears that the statute is arguably not applicable to an ABC on the basis that a sale or exchange lacks the element of the transfer being made in trust for the benefit of creditors. Delaware case law does not address whether an ABC is a sale or exchange governed by DGCL §271(a). The decision of a Massachusetts court rejected this interpretation of a nearly identical statute in *In re E. T. Russell Co., Inc.*, 291 F. 809 (D. Mass. 1923). That court was faced with a challenge to the power of the directors to authorize, without shareholder approval, an ABC. The court's analysis concluded that a sale or exchange is distinguishable from an ABC because the latter has the element of a trust. *See also* 6 AM. JUR. 2D. §2.

²⁶ 11 U.S.C. §305(a).

²⁷ *Credit Managers Ass'n v. National Indep. Bus. Alliance*, 162 Cal. App. 3d 1166 (1984); *In re A&B Liquidating, Inc.*, 18 B.R. 922 (Bankr. E.D. Va. 1982).

²⁸ *See* *In re Gary Player Direct, Inc.*, Case No. ND-00-11780-RR (Central Dist. 2000).

²⁹ *In re Ed Jansen's Patio, Inc.*, 183 B.R. 643, 644 (Bankr. M.D. Fla. 1995); *In re Kidwell*, 158 B.R. 203 (Bankr. E.D. 1993); *In re Johnston Hawks, Ltd.*, 72 B.R. 361, 363, *aff'd*, 885 F.2d 875 (1989) (unpublished).

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