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Non-Bankruptcy Alternative: Assignments for Benefit of Creditors

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With the costs of a chapter 11 filing rising and bankruptcy courts becoming less desirable for small to middle market companies in financial distress,¹ insolvency counsel should revisit non-bankruptcy alternatives available to their clients. While a number of different processes may be available depending on a debtor's predicament, this article concentrates on one: Assignments for the Benefit of Creditors (ABC). ABCs are an assignment of all of a company's assets under state law for the purpose of liquidation and satisfaction of creditors' claims.

Title to all the debtor's property is transferred to a trustee, with authority to liquidate the debtor's affairs and distribute proceeds equitably to creditors.² The business entity chooses who will liquidate its assets for the benefit of the creditors. In some, but not all, states, the process is required to be supervised by a court.

ABCs are generally used for the orderly liquidation of a debtor's assets and payment of corresponding liabilities. Most often ABCs are used in lieu of the company filing a Chapter 7 bankruptcy case or having assets foreclosed on by secured creditors. Sometimes an assignee will operate the debtor's business to maximize value; but it is rare as operating the business without secured creditor consent, or at a loss, leaves the assignee at risk of liability for diminishing the estate.³

ABCs are not reorganization mechanisms. If the debtor can be reorganized, then an out-of-court workout, composition or extension agreement process may be better alternatives. In rare instances, high-net-worth individuals may look to an ABC, but the inability to get a discharge of the debts usually makes this alternative not practical.

The ABC assignment is commenced when the assignment contract, which creates an irrevocable trust, and its accompanying schedules, are "accepted" by the assignee. The assignee is a fiduciary, responsible to all creditors in much the same way a trustee in bankruptcy is. Since an ABC is not a reorganization process but rather a liquidation process, "managing operations" is not often done and the assignee oversees the liquidation of the debtor's assets.

The law of the state where the assignment takes place will dictate whether the matter will be court-supervised, such as New York, or not, as in California where the assignment is not filed at all. The ABC is provided to scheduled creditors regardless of whether the process is court-supervised or not, and creditors are provided a proof of claim form that must be submitted by a claims bar date.

There is no "governing law" over the choice of the assignee. The assignee is usually selected by the debtor, and the choice is subject to court approval in those states requiring court supervision over ABCs. Where there is a secured creditor with a lien on all of the debtor's assets, that creditor has the right to take possession of its collateral if it does not agree with the choice of the assignee.

Once the ABC is made, the debtor loses control over the affairs of the company and control over the assets belongs to the assignee; the debtor has no say in the assignee's actions. To the extent the debtor has concerns about the actions of the assignee, it should address those in the interview process whereby the assignee is selected.

ABCs have been used by lawyers for years, and many states have comprehensive statutory schemes to address the administration of assignment estates. State-by-state

variances can be significant and require careful review of the applicable law before utilizing an ABC.

New York Law on ABCs

New York's statutory scheme is codified at New York Debtor Creditor Law, Article 2, and encompasses 24 sections, including the Power of the Court (Section 15), the Duties of the Assignee (Section 14), Notice to Creditors to Present Claims (Section 5) and Wages, Commissions, Preferred Claims (Section 22). Of note throughout is that an ABC is supervised by a Supreme Court judge in the county in which the debtor resided (Section 2, Jurisdiction of Proceedings). "[A]ll proceedings and hearings under this article had in the Supreme Court upon the return of a citation or order shall be had at a special term of said court held in the county where the debtor resided at the time of the assignment."

The General Assignment document, or contract, must comply with Section 3 which requires the assignment be in writing, specifically state the "residence" and kind of business carried on by the debtor at the time of the assignment, the place at which such business shall then be conducted, if such place be in a city, the street and number thereof, and if in a village or town such apartment designation as shall reasonably identify such debtor.

The assignee is selected by the debtor and subject to court approval and is required to post a bond (Section 6), file an inventory of the assigned assets (Section 4) and among other things, the court may, upon the application of the assignee and for good and sufficient cause shown, and upon such terms as he may direct, authorize the assignee to sell, compromise or compound any claim or debt belonging to the estate of the debtor (Section 19). The assignee is subject to removal by creditors, for cause (showing misconduct or incompetency of the assignee) (Section 8). Creditors are required by Section 5 to file written, verified claims with the assignee to share in any recoveries.

Section 22 addresses the priority of unpaid employee wages. Like many similar statutes across the country, the dollar limitation for priority wages is substantially below that provided for in bankruptcy. In New York the limit is \$1,000 per employee earned and unpaid in the 90 days immediately preceding the ABC. This creates a conflict for a debtor's management where applicable labor statutes require payment in full of unpaid wages and benefits upon the employees' termination and failure to pay such unpaid wages can create personal liability for officers, director and/or members.

New York has also imposed criminal penalties for knowing failures to pay wages, as well as failing to provide wage supplements or benefits, such as reimbursement for expenses, health, welfare and retirement benefits, and vacation, separation and holiday

pay. See New York Labor Law §198(c); *People v. Milton C. Johnson Co.*, 337 N.Y.S.2d 477 (N.Y. City Crim. Ct. 1972); c.f. *People v. Lustig*, 420 N.Y.S.2d 624 (N.Y. App. Term 1979) (requiring that officer have active involvement or actual authority in running company to be liable). For California law, see §1197.1, which exposes "any employer or other person acting either individually or as an officer, agent, or employee of another person" to liability.

New Jersey Statutes

New Jersey's statutes on ABCs are found at Title 2A Administration of Civil and Criminal Justice. Provision 2A:19-1 defines a general assignment, and 2A:19-2 requires that assignments must be for equal benefit; preferences are void. Corporations are entitled to make assignments pursuant to A2:19-44 and the assignor is a resident of the county in which its principal office is located (A2:19-45). ABCs are court-supervised, though there is no single statute referencing that. Rather, throughout the statutes there are references to the authority of the court.

A2:19-7 requires the assignee "to record the assignment, including the inventory and list of creditors with their claims, in the county where the assignor resides and in any other counties or states where he may deem it necessary." A copy is also "filed by the assignee with the surrogate of the county where the assignor resides or with the clerk of the Superior Court."

The assignee is required to publish notice of the assignment in the county where the debtor resides for four consecutive weeks and include that "all claims of creditors against the estate must be presented under oath to the assignee within 3 months from the date of the general assignment, or be barred from participating in a dividend of said estate." (Section A2:19-8). There is a requirement the assignee post a bond with the court before undertaking their responsibilities as assignee. The assignee's duties and responsibilities are detailed beginning at A2:19-13 and include the right to continue a debtor's business operations upon approval of the court.⁴ All sales of personalty by the assignee are subject to court approval (Section A2:19-19).

Priority wages are addressed in Section A2:19-30. However, similar to New York law, the dollar limitation in the statute is substantially below the limits in bankruptcy cases. New York's priority wage limit is \$1,000, while New Jersey's limitation is a mere \$300. As such, a review of unpaid wages that would otherwise be entitled to priority needs to be done before the decision to make an ABC is finalized.

New Jersey provides for landlords to have a lien for unpaid rent, not exceeding one year at A2:19-31. Of course the validity of a properly perfected secured creditor likely takes

priority over the landlord's lien, though having a landlord waiver makes the issue much less troublesome.

Section 2A:19-47 states that "in case a corporation shall, at any time after the making of a general assignment, be adjudged insolvent and a receiver thereof be appointed by the Superior Court, the said court may, whenever it may deem it to the interest of the stockholders or creditors, remove the assignee and direct and compel him to transfer and convey the trust estate in his hands to the receiver to be administered under the direction of said court. The assignee shall thereupon present his accounts to the Superior Court for settlement and allowance." In practice, assignees are generally not replaced by receivers, although the right exists.

New Jersey has a "preferential transfer" statute, found at 2A:19-3. Defined as a transfer made within four months of the execution of the ABC, the statute requires proof of intent to prefer the receiving creditor. Care should be taken to insure that potential recoveries under Section 547 of the bankruptcy code are not more substantial than under state law before the decision is made to make an ABC.

New Jersey also has a "bulk sales" statute that governs the transfer of assets for sale to third parties (New Jersey Statutes—Title 54 Taxation—54:50-38). New Jersey's version of Uniform Commercial Code Article 6 was repealed in the early 1990s. Article 6 Section 103(f) contained an exemption from the bulk transfer requirements for an assignee for the benefit of creditors; that exemption is not on the face of the surviving New Jersey statute, though it likely is waived with the approval of the supervising state court.

A recent practice in New Jersey and California involves assignees seeking court orders approving sales of assets "free and clear" of existing liens. This concept is more commonly known and heretofore thought to be the sole province of the bankruptcy courts under Section 363(f). In both states, challenges have been raised that the sale order under such circumstances was preempted by the bankruptcy code and therefore unconstitutional. The decision by the U.S. Court of Appeals for the Ninth Circuit in *Sherwood Partners v. Lycos (In re Thinklink)*, 394 F.3d 1198 (9th Cir. 2005) remains good law (at least in the Ninth Circuit). That court found that recovery of preferences by an assignee was preempted by the bankruptcy code and was the exclusive right of a trustee (or estate representative).⁵ The outcome of this issue remains to be seen.

Other Governing Statutes

True in every state that has adopted the revised Uniform Commercial Code, both New York and New Jersey provide that the assignee for the benefit of creditors has the rights of a lien creditor upon the making of an ABC. See New Jersey Ann. Stat. 12A:9-309; New York Uniform Commercial Code, Sub-Part 2, §9-309(12). This provision effectively

blocks creditors who have unperfected security interests in a debtor's assets from perfecting a lien post assignment, leaving the creditor where it was at the time of the assignment.

It does not prevent a creditor from filing suit to try to collect its claim (though only against the assignor and not the assignee) as the statute is not an automatic stay to collection efforts. But if the creditor can only fix the amount owed and not enforce a post-assignment judgment, the effect is practically the same. Additionally, the federal priority statute, 31 U.S.C. §3713, must be accounted for in looking at the priority of claims. Failure to recognize the priority under this statute for a claim of any agency of the federal government carries personal liability to the fiduciary despite any exculpatory language in the statutes or assignment document.

ABCs are not always the best alternative for a debtor. Care needs to be taken to insure that assets that have value that might be lost through application of an ipso facto clause in the underlying contract are identified before the ABC is finalized. Once the ABC is executed and accepted, the debtor can't undo that action to reclaim the lost assets. Examples of such assets would be under-market leases of real property, royalty agreements and mineral/oil rights.

Endnotes:

1. For a discussion on small and medium "enterprise" issues in bankruptcy and related recommendations, see the American Bankruptcy Institute's Commission for the Study of Reform of Chapter 11 (December 2014).
2. Black's Law Dictionary; also see *Clark v. Williard*, 292 U.S. 112 (1935).
3. For example, an assignee that allows a third party to operate a debtor post assignment, without securing the performance by the third party to pay the operating expenses and not take off with the assets, is likely to be held liable for breach of fiduciary duty to the creditors of the estate.
4. As noted above, this right is rarely exercised without good justification and protection of the value of the assigned assets.
5. California courts have distinguished this decision as being a decision of a lower federal court and not binding on state courts. Practically, however, the *Sherwood Partners* decision remains controlling when an assignee is seeking recovery from an out-of-state creditor.

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