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BANKRUPTCY ALTERNATIVES: THE IMPACT ON TRADE CREDITORS

Presented by:

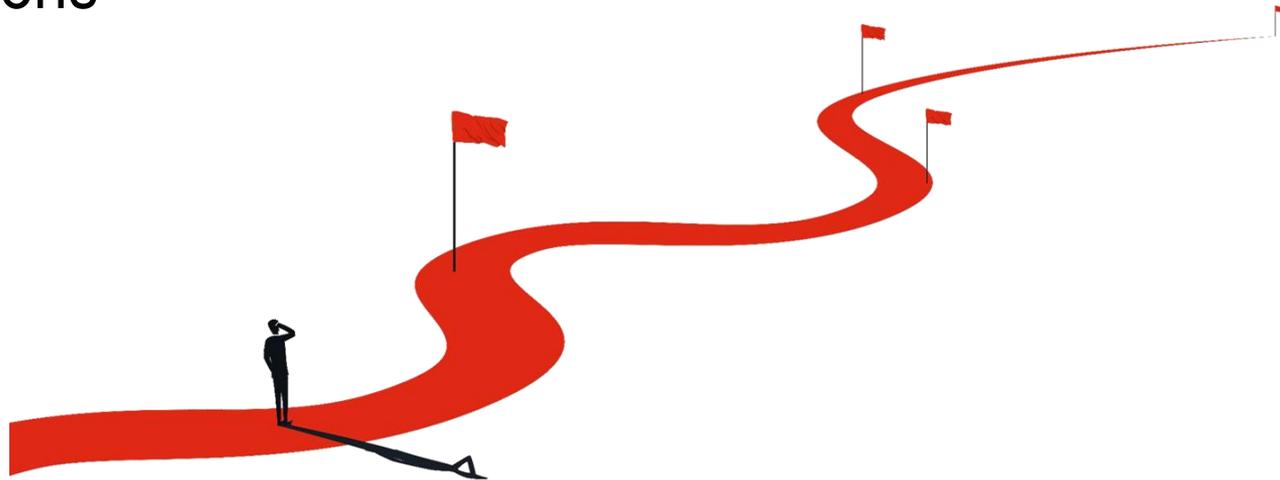
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| NON-BANKRUPTCY ALTERNATIVES

- Assignment For the Benefit of Creditors
- Receiverships
- Uniform Commercial Code Article 9 Sales
- Out of Court Extensions/Compositions
- Liquidations



ASSIGNMENT FOR THE BENEFIT OF CREDITORS (“ABC”) – OVERVIEW

- Formal out-of-court liquidation – state alternative to Chapter 7 bankruptcy
 - Governed by state law
 - Statutory authority and common law
 - ABC procedures vary from state to state



| ABC'S – OVERVIEW

- ABC arises by contract
 - Agreement between debtor/assignor and assignee
 - **Assignee is selected by debtor/assignor!**
 - Possibility of assignee bias in favor of:
 - assignor (debtor)
 - secured lender



| ABC – OVERVIEW

- An ABC vests title to an assignee to all debtor's/assignor's property, subject to liens/encumbrances
- Assignee is a fiduciary for all of debtor's/assignor's creditors
 - Liquidates debtor's/assignor's property
 - Notifies creditors of ABC; claims bar date; other matters
 - Investigates/pursues claims vs. third parties
 - Reconciles claims vs. debtor/assignor
 - Distributes cash proceeds to assignor's creditors according to recognized state law priorities
 - Provides final accounting at conclusion of case

| ABC'S – OVERVIEW

- Court supervision? Varies by state
 - Some states provide for court supervision of the ABC and assignee
 - Other states provide limited oversight
 - No court supervision
 - Assignee could follow state law applicable to liquidating business/assets



ABC'S – ASSIGNEE'S STANDING TO PURSUE CLAIMS AGAINST THIRD PARTIES

- An assignee, like a Chapter 7 bankruptcy trustee, has standing to prosecute claims that could be asserted by debtor/assignor and defend claims vs. debtor/assignor
 - Assignee is successor in interest to/“legal representative” of debtor/assignor



ABC'S – ASSIGNEE'S AVOIDANCE POWERS

- UCC § 9-309 gives assignee rights of a perfected secured creditor as of date of assignment
 - Similar to Chapter 7 trustee's status as a hypothetical lien creditor
- Secured creditors cannot enforce unperfected security/lien interest against debtor's/assignor's assets



ABC'S – ASSIGNEE'S POWER TO PURSUE PREFERENCE CLAIMS

- Some states, like California, have preference statutes similar to Section 547
- Other states have preference statutes like Bankruptcy Act of 1898
 - Different reachback period (e.g., Wisconsin/New York/New Jersey – 4 month reachback)
 - Different proof requirement – (e.g., New Jersey – intent to prefer the creditor over other creditors)
 - No preference defenses, like new value and ordinary course of business
 - Recent rash of preference actions in Wisconsin and New Jersey ABC's
- Other states have no preference statute at all
 - Illinois, Delaware

| ABC'S – PREFERENCES

- Division regarding whether state law preference claims are preempted by the Bankruptcy Code
 - Ninth Circuit Court of Appeals, in *Sherwood Partners* decision, holds that the Bankruptcy Code preempts, and, therefore, invalidates California's preference statute



| ABC'S – PREFERENCES

- California state appellate court decisions reject the Ninth Circuit's holding in *Sherwood Partners* and have upheld California's preference statute as not preempted by the Bankruptcy Code
- The United States District Court for the Western District of Wisconsin, in *Ready Fixtures Co. v. Stevens Cabinets*, upheld Wisconsin's preference statute as not preempted by the Bankruptcy Code, rejecting the Ninth Circuit's holding in *Sherwood Partners*



| ABC'S – CLAIMS PRIORITIES

- Similar to bankruptcy
- Assignee must liquidate assignor's assets and distribute proceeds based on state law priorities



| ABC'S – CLAIMS PRIORITIES

- First in Priority: Properly perfected secured creditor gets first position on collateral
- Next In Line: Costs of administering ABC
 - Administrative costs
 - No Section 503(b)(9) priority claim for goods suppliers (goods delivered within 20 days of bankruptcy)
 - Assignee's out-of-pocket expenses
 - Assignee's professional fees
 - Assignee's statutory fees

| ABC'S – CLAIMS PRIORITIES

- State law priorities are next level in priority
 - Taxes – federal/state/local
 - Unpaid wages
 - Other employee benefits
 - Customer deposits
- Bottom of claims priority ladder: General unsecured claims

| ABC'S – CLAIM RECONCILIATION

- Assignee must give notice of ABC to all creditors of debtor/assignor
- Assignee sets claims bar date by which creditors may assert claims against debtor/assignor
 - Creditors that fail to timely file proof of claim may not share in distribution
 - Assignee can question any filed claim that exceeds amount reflected in debtor's/assignor's books and records
 - No right to interest accruing during ABC of insolvent debtor

| ABC'S – SALES

- States vary on whether sale in an ABC requires court approval
- Most states do not permit assignee to sell assets free and clear of liens/security interests as can be done in bankruptcy



| ABC'S – SALES

- Either:
 - Assignee must obtain sufficient value for collateral to pay off secured creditor; or
 - Secured creditor must consent to assignee's sale of collateral
 - Collateral proceeds paid to secured creditor
 - Secured creditor releases security interest

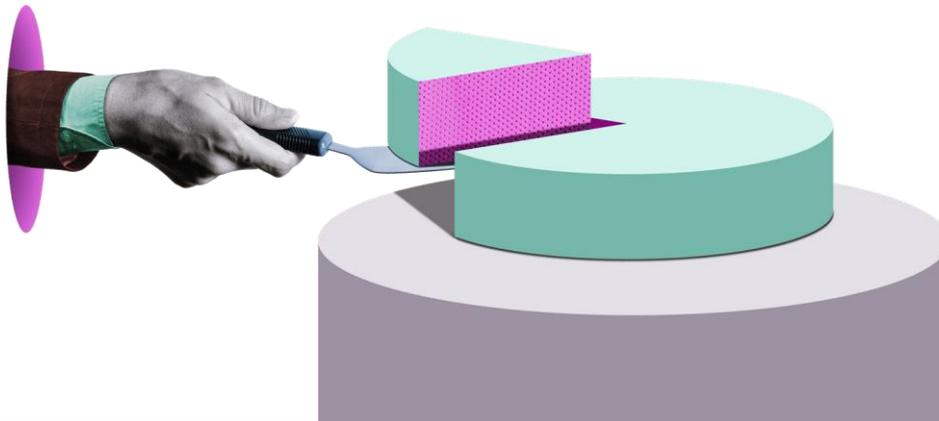
ABC'S – LEASES/EXECUTORY CONTRACTS

- “Ipso Facto Clause”
 - Authorizes termination of lease/contract upon debtor’s insolvency/bankruptcy filing/appointment of fiduciary
 - Invalidated in bankruptcy
- State law does not invalidate “Ipso Facto Clause”
- State law does not grant any authority for assumption/assignment of leases/executory contracts that contain contractual prohibition against assignment
 - Assignable only if contract permits or contract parties agree
 - Assignee cannot realize any value on below-market real estate leases and other contracts



| ABC'S – DISTRIBUTION OF ASSETS

- No distribution to unsecured creditors until all secured claims, taxes, priority wage and other claims with priority have been paid in full
- Typically, pro rata distribution
 - Each unsecured creditor shares in distributed dollars based on
 - Amount of its allowed claim; and
 - Total amount of all allowed claims
 - No one unsecured creditor of any given class can receive more (on a % basis) than any other member of the same class



| ABC'S – FINAL ACCOUNTING

- When all estate funds have been distributed, assignee must provide an accounting to all creditors
- Accounting concerns all funds handled by assignee during administration of estate



| ABC VS. CHAPTER 7 BANKRUPTCY

- Advantages of ABC
 - Usually faster
 - Cheaper
 - Potentially larger distribution to unsecured creditors
 - Assignee sometimes selected by creditor



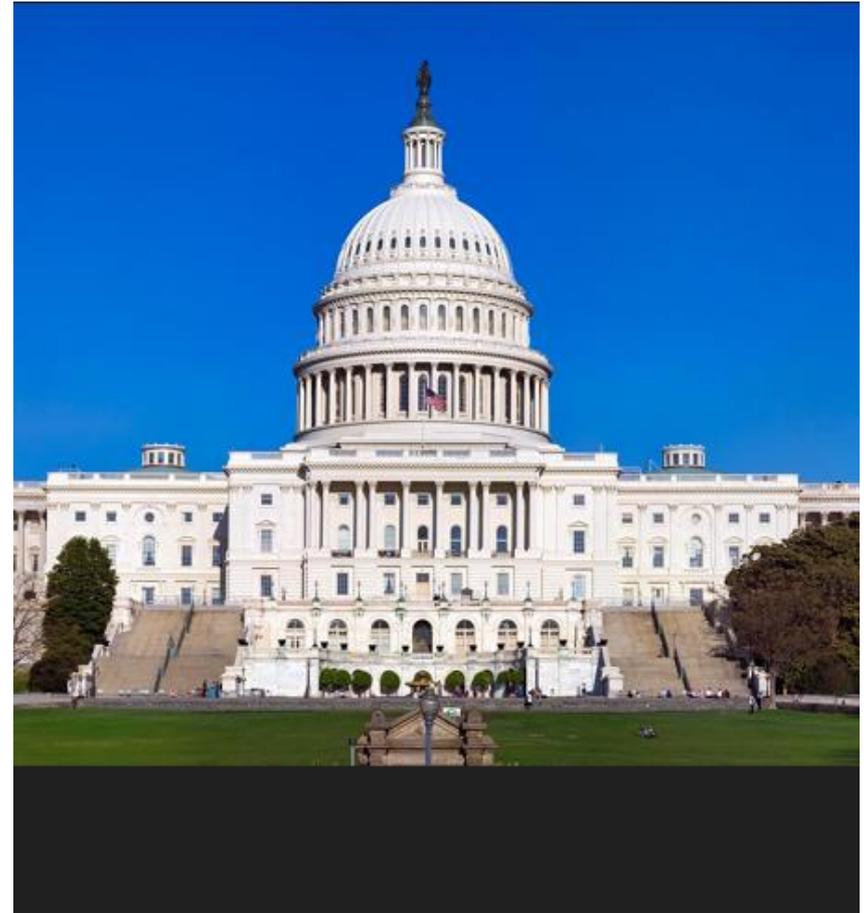
| ABC VS. CHAPTER 7 BANKRUPTCY

- Disadvantages
 - Not uniform – varies by state
 - Assignee often selected by debtor/assignor and not monitored
 - Sale process not favorable for sale of business
 - Executory contracts/leases containing anti-assignment provisions not assignable
 - No discharge for individuals



| RECEIVERSHIPS

- State or Federal
- Commenced by court proceeding
 - Secured creditor can commence, seeking to protect collateral
 - Trade creditors cannot commence receivership proceeding
- Receiver is fiduciary appointed to administer and/or liquidate a business or specific asset
- Appointment of receiver remedy frequently found in loan agreements
- Considered extraordinary remedy by courts



| RECEIVERSHIPS – RECEIVER DUTIES

- Usually all about court order appointing receiver and authorizing the following
 - Injunction against creditor action
 - Receiver can
 - Take possession of debtor's assets
 - Collect accounts and other sums due to the debtor
 - Manage and operate the debtor's business and property, including paying ongoing expenses to the extent necessary until sold
 - Employ, compensate and discharge employees necessary to manage or control the debtor's assets
 - Sell assets with or without court approval depending on order and value
 - Commence litigation
 - Assume/Assign/Reject leases settle disputes

| RECEIVERSHIPS

- Among factors court considers in appointing receiver:
 - Fraudulent conduct
 - Imminent danger of loss of collateral
 - Irreparable injury to secured lender
- Receiver can be requested by government:
 - SEC
 - Department of Environmental Protection
 - State and Federal criminal investigations



RECEIVERSHIPS – WHAT TRADE CREDITORS SHOULD LOOK FOR

- Does receivership court order grant injunction preventing creditor collection activity?
- Claims bar date and method for asserting proof of claim, which is determined by:
 - Statute or
 - Court order
 - Inclusion of claims bar date in order appointing receiver



| RECEIVERSHIPS

- Some states refer to assignee in an ABC as a “receiver” – different from court appointed receiver
 - Example: Wisconsin
- Role of receiver is often more limited than assignee in ABC
 - Scope of receivership often limited to specific assets
 - Receiver’s actions more closely monitored by court



| RECEIVERSHIPS

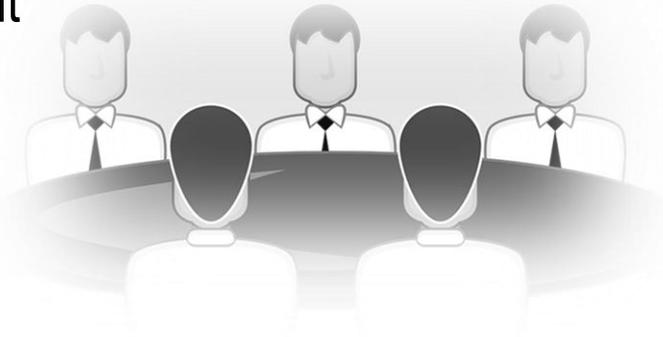
- Recently enacted receivership statutes
 - Numerous states have enacted comprehensive receivership statutes in the past 20 years:
 - Oregon (2018)
 - Missouri (2016)
 - Ohio (2013)
 - Minnesota (2012)
 - Washington (2004)
 - Uniform Commercial Real Estate Receivership Act – adopted by several states
 - Automatic stay of creditor action?
 - Sale of assets free and clear of liens?
 - No provision for assignment of non-assignable executory contracts/leases

RECEIVERSHIPS/ ABC'S ENHANCED VENDOR ROLE

- Who are key vendors?
- Formation of ad hoc trade creditor group/committee
- Committee's role
 - Investigation of lender's secured claim and claims against secured lender/other third parties
 - Monitor sale process
 - Negotiate with secured lender, creditors and other constituencies

I INVOLUNTARY BANKRUPTCY RISK

- Three or more petitioning creditors can join in an involuntary bankruptcy petition
 - Their claims must be unsecured, not contingent
 - Not subject to a bona fide dispute as to
 - Liability or
 - Amount
 - Totaling not less than
 - \$16,750 for bankruptcy cases filed on and after 4/1/2019
 - Debtor has 12 or more unsecured creditors
- If debtor has fewer than 12 unsecured creditors, excluding, employees, insiders, and transferees of voidable transfers (e.g., preference claims), only one petitioning creditor with claim of at least the required statutory minimum



I INVOLUNTARY BANKRUPTCY RISK

- If debtor opposes involuntary petition, petitioning creditors must prove debtor generally not paying debts as they become due, unless debts are subject to bona fide dispute as to liability or amount
- Debtor and/or assignee or receiver can move for abstention
 - Bankruptcy court can dismiss or suspend the bankruptcy case where appropriate if “interests of creditors and the debtor would be better served by such dismissal or suspension”



SECURED PARTY FORECLOSURE OF COLLATERAL

- In furtherance of enforcement of security interest/collection and/or liquidation of secured creditor's collateral as a result of debtor's default under its agreements with its secured creditor
- Governed by Article 9 of Uniform Commercial Code



“FRIENDLY” VS. “UNFRIENDLY” ARTICLE 9 FORECLOSURES

- **“Friendly” Foreclosure** process is basically the same as an adversarial process (notice and sale procedures), minus the contested lawsuit
 - Debtor can **consent** to the secured party’s seizure and sale of the collateral as part of a peaceful possession arrangement between the debtor and secured party
- **“Unfriendly” Foreclosure** process includes a contested lawsuit



SECURED PARTY FORECLOSURE OF COLLATERAL

- Notice of sale of collateral addressed to the following persons:
 - Debtor
 - Guarantors/Secondary obligors
 - Other creditors with security interest in collateral subject to sale
 - 10 day safe harbor/form of notice
 - No required notice of sale to unsecured creditors



SECURED PARTY FORECLOSURE OF COLLATERAL

- Foreclosure sale
 - Public auction or private sale
 - All aspects must be “commercially reasonable”
 - Proceeds paid to secured creditor with right to assert deficiency claim for balance due
 - Sale free and clear of foreclosing security interest and junior security interests and most junior lien interests
 - Unsecured claims wiped out
 - Scrutinizing foreclosure sales to insiders and/or for low sale price

SECURED PARTY FORECLOSURE OF COLLATERAL

- Foreclosure sale
 - Low sale price does not make foreclosure sale “commercially unreasonable” but suggests scrutiny of transaction
 - However, where secured party, person related to secured party or guarantor of secured debt purchases collateral at a foreclosure sale at a price significantly below the range of proceeds that a complying disposition to an unaffiliated third party would have realized, the secured party’s deficiency claim is reduced by the amount such third party would have paid

TRADE CREDITORS' RESPONSE TO UCC ARTICLE 9 FORECLOSURE SALE

- Unless process is transparent, trade creditors might consider participating in an involuntary petition
- Could lead to formation of out of court committee



UCC ARTICLE 9 FORECLOSURE SALE VS. BANKRUPTCY: PROS AND CONS

- Pros
 - Faster than bankruptcy sale process
 - Generally less expensive than bankruptcy sale
- Cons
 - Limited scope – only addresses secured party's collateral; not unsecured claims
 - Does not dispose of other claims against debtor as bankruptcy would
 - Successor liability risk
 - Lack of transparency for unsecured creditors



OUT-OF-COURT COMPOSITION/EXTENSION

- Consensual payment arrangement with debtor's unsecured creditors
 - In lieu of Chapter 11 or ABC/Receivership
 - Binds only assenting creditors
 - Often negotiated with unofficial committee of unsecured creditors
- Not currently widely used



OUT-OF-COURT COMPOSITION/EXTENSION

- Unofficial committee usually requests forbearance from trade/other creditors, pending investigation, negotiation of arrangement
 - Review of loan documents to discover deficiencies justifying challenge of secured claim(s)
 - Financial review to:
 - Monitor liquidation
 - Determine distribution prospects/amounts and potential to increase recovery for general unsecured creditors



OUT-OF-COURT COMPOSITION/EXTENSION – THE AGREEMENT AND SOLICITATION

- Negotiation of extension or composition agreement
- Extension
 - 100% distribution
 - Full payment of participating creditors' claims over time
- Composition
 - Less than 100% distribution
 - Single cash payment or deferred payments and/or property distribution in amount(s) less than full amount of participating creditors' claims
 - Payment(s) in full settlement of claims of participating creditors
 - Non-participating creditors free to collect their entire claim

OUT-OF-COURT COMPOSITION/EXTENSION – ADVANTAGES

- Avoids stigma of bankruptcy
- More flexible
- Faster if there is consensus
- Much less expensive
- More dollars available for creditors

OUT-OF-COURT COMPOSITION/EXTENSION – DISADVANTAGES

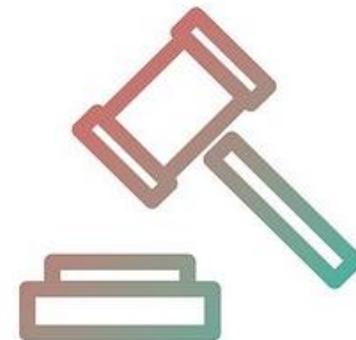
- No automatic stay (unlike bankruptcy) preventing lawsuits/other collection action
- Inability to sell assets free and clear of liens
- Need for near unanimous creditor approval of settlement
 - Agreement does not bind/discharge claims of non-consenting creditors
 - Contrast to confirmed Chapter 11 plan: binds dissenting creditors to treatment of unsecured claims

OUT-OF-COURT LIQUIDATION RECENT CASE

- A.C. Moore Arts & Crafts, Inc. and A.C. Moore Incorporated
 - Process began in 4th quarter, 2019.
 - Creation of ad hoc committee of vendors in December, 2019
 - Committee retained counsel and shared financial advisor with ad hoc committee of landlords
 - Debtor paid advisors' fees
 - Standstill period
 - Negotiation of settlement
 - Solicitation of creditors' acceptance of settlement

| LIQUIDATION

- Debtor announces it is closing its doors and liquidating
- Distribution tendered?
 - In full settlement of claim?
- Response
 - Threat of involuntary bankruptcy petition
 - Attempt to obtain transparency about the liquidation process as the price for not filing involuntary petition
 - Formation of out of court creditors' committee



| QUESTIONS?





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Education

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Michael Papandrea provides counsel to debtors, creditors' committees, individual creditors, liquidating trustees, and other interested parties with respect to corporate bankruptcy and creditors' rights matters, including bankruptcy-related litigation.

Reliable and efficient, Mike is appreciated for his innate ability to effectively apply and convey his understanding of the law and general business principles with respect to complex issues, both while providing advice to clients and while aggressively advocating on their behalf. Mike works tirelessly to understand clients' needs and provide practical solutions that are reasonable, balanced, and favorable to the clients he serves.

Mike enjoys keeping clients and relevant industry professionals in the loop regarding bankruptcy, insolvency, and creditors' rights issues, regularly writing articles for and speaking to professionals in the credit and risk management space. Mike also takes pride in his commitment to the community and provides pro bono representation to individuals and nonprofit organizations regarding bankruptcy and foreclosure-related matters.

Mike has been recognized by the *American Bankruptcy Institute's* 40 Under 40 program, which honors emerging leaders in the insolvency profession who are committed to the highest standards of achievement at work and in their communities.

Prior to joining the firm, Mike held multiple clerkships in the U.S. Bankruptcy Court; he clerked for the Hon. Jerrold N. Poslusny, Jr. (District of New Jersey), the Hon. Ashely M. Chan (Eastern District of Pennsylvania), and the Hon. Gloria M. Burns (Chief Judge, District of New Jersey). Mike applies the valuable insights learned from working closely and directly with these members of the judiciary to his everyday practice..

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