

CREDITOR'S RIGHTS TOOLKIT

What Are Some Alternatives to Chapter 11 and How Do They Affect Creditors?

There are many reasons why a company might be experiencing financial distress, including overwhelming debt, cash flow problems, substantial litigation claims, and/or an economic downturn. Companies sometimes use Chapter 11 as a vehicle to address these issues, especially since Chapter 11 allows the company to reorganize and continue as a going concern. However, Chapter 11 is an expensive process and may not be the best option for a financially distressed company. This article discusses alternatives to Chapter 11 and how these alternatives may affect creditors.

Key Issues

WORKOUT

In a workout, a financially distressed company attempts to solve its financial problems by negotiating a modification of its debts with creditors. The company and creditors may agree that its creditors will accept less than full payment in full satisfaction of such claims, an extended timeline to pay claims, or some other financial arrangement agreeable to the parties. In a workout, the management of the company remains in place, and the business continues to operate as normal since the objective of the workout is focused on rightsizing the company's debt structure.

Creditor Issues:

- Only the creditors that agree to the workout are affected by the terms of the workout.
- A creditor who does not wish to be a part of the workout may pursue all available remedies to collect amounts owed to such creditor.
- Aggressive action by individual creditors, or the failure of one or more key creditors to consent to the workout, may cause a debtor to choose an alternate restructuring strategy.

ASSIGNMENT FOR THE BENEFIT OF CREDITORS

An assignment for the benefit of creditors (ABC) is a state law liquidation process by which a financially distressed company (referred to as the assignor) transfers its assets to a third-party fiduciary (referred to as the assignee). See [What Is an Assignment for the Benefit of Creditors and How Does It Differ From a Bankruptcy?](#) (PDF). The assignee is responsible for liquidating the assets and distributing the proceeds to the assignor's creditors, pursuant to the priorities established under applicable law. An ABC is not an option for a business that does not wish to liquidate and close down operations. With that said, an assignee can run the business for a period of time in order to maximize value for creditors by selling the business as a going concern.

Creditor Issues:

- There is no automatic stay in an ABC and thus creditors are free to continue to pursue their claims against the assignor (and collect via the ABC).
- A company does not need approval of its general unsecured creditor body to effectuate an ABC, although secured creditor consent is required to sell assets free and clear of the secured creditor's liens.
- Amounts due creditors will be addressed as part of the ABC claims process. Creditors of the assignor must timely file a claim in order to share in any distributions from the ABC funds.
- Some states permit the assignee to attempt to claw back funds paid to creditors prior to the ABC being effectuated, similar to a preference claim brought pursuant to the Bankruptcy Code.
- Because the assignor remains a legal entity, creditors who believe that the company should be liquidated under federal bankruptcy law rather than via an ABC can seek to have the company put into bankruptcy by filing an involuntary bankruptcy petition and, if successful, this can disrupt or terminate the ABC.

CHAPTER 7

Unlike Chapter 11 which can be used to restructure a company with management remaining in possession of the business, Chapter 7 is solely a liquidation tool under federal bankruptcy law. Upon the filing of the Chapter 7 case, a Chapter 7 trustee is appointed, and the directors and officers of the company no longer have any decision making over the affairs and assets of the company. The Chapter 7 trustee is responsible for liquidating the assets of the company and making distributions to creditors. In some very unusual situations, the Chapter 7 trustee may continue to operate the business for a short period of time if needed to maximize value for creditors, but that is not the norm.

Creditor Issues:

- The automatic stay applies to stay any pending litigation a creditor has against the company or its assets. See [Automatic Stay – Why Can't I Just Keep Collecting on Pre-Bankruptcy Claims?](#) (PDF)
- A company does not need approval of its general unsecured creditor body to file for Chapter 7.
- The Chapter 7 trustee will establish a deadline for creditors to file proofs of claim.
- Chapter 7 cases in which there are assets available tend to progress slowly, such that distributions to unsecured creditors might not occur, if at all, until years after the case is commenced.

- In a Chapter 7 case, the trustee is paid by a statutory formula through which the trustee gets to keep a percentage of the amounts distributed to creditors. As such, the Chapter 7 trustee is incentivized to assert claims and causes of action, including preference claims, against creditors who received payment in the 90-day period prior to the Chapter 7 being filed. See [How Can You Protect and Defend Your Business From Preference Actions? \(PDF\)](#).

Takeaway

A financially distressed company has numerous options when trying to address its financial challenges. These options can result in an ongoing business or liquidation of the company. These options also affect the company's creditors both in terms of amount and timing of payment and potential claims against such creditors to claw back funds received by the creditors. A creditor dealing with a company that is financially distressed should consult experienced counsel to ensure that its rights are fully protected.