XYZ CORP (XYZ) IS A wireless technology company which was formed four years ago. Since that time, more than $25,000,000 in equity investments has poured into XYZ. Additionally, XYZ has incurred more than $5,000,000 in unsecured debt that it is now unable to pay. While XYZ has developed some exciting products, it continues to operate on a negative cash flow basis, and is unable to obtain further funding through either equity investment or debt placement. The Board of Directors of XYZ has considered the realistic alternatives available to XYZ. At this point, XYZ is insolvent (XYZ's debts exceed the value of its assets). The board recognizes that, under the circumstances, it has fiduciary obligations running to XYZ's creditors and that it is required to act in a manner reasonably designed to maximize creditor recovery.

Among the alternatives considered by the board are the following: (1) merging with, or being acquired by, a qualified candidate; (2) commencing a formal bankruptcy proceeding (chapter 11 reorganization or a chapter 7 liquidation); (3) engaging in an out-of-court debt restructuring or workout; (4) shutting down the business and simply closing the doors (an informal death); (5) streamlining the company and focusing on a core business or technology; or (6) making an assignment for the benefit of creditors.

The board has determined that a going concern sale of XYZ's business is in the best interests of the company and its creditors and has identified two potential purchasers who have expressed interest in the acquisition. However, neither purchaser will acquire the business if the assumption of XYZ's unsecured debt is involved. Further, the situation is deteriorating rapidly. XYZ is burning through its cash reserves. XYZ's key employees are aware of its financial difficulties and creditors of XYZ are pressing for payment. XYZ's board has been advised and has now concluded that an assignment for the benefit of creditors (ABC) may be the most appropriate course of action.

In many instances, where the goal is to transfer the assets of the troubled business to an acquiring entity free of the unsecured debt incurred by the transferor and wind down the company in a manner designed to minimize negative publicity and potential liability for directors and management, the most advantageous and graceful exit strategy can be an ABC.

An assignment for the benefit of creditors can serve as a very useful and efficient means of accomplishing a wind down and the liquidation or going concern sale of a troubled business unable to reorganize, maximizing a secured creditor’s recovery from the assets of a distressed debtor and/or facilitating a buyer’s acquisition of a troubled business or assets from an entity burdened with unsecured debt (and, with the cooperation of secured creditors, secured debt).

The process of an ABC is commenced by the distressed entity (the “assignor”) entering an agreement with the party which will be responsible for conducting the wind down and/or liquidation or going concern sale (the “assignee”) in a fiduciary capacity for the benefit of the assignor’s creditors. The assignment agreement is a contract under which the assignor transfers all of its right, title, interest in, and custody and control of its property to the third-party assignee in trust.

The assignee liquidates the property and distributes the proceeds...
to the assignor’s creditors. In an ABC (as in a formal federal bankruptcy proceeding), unsecured creditors of the assignor have no right to pursue the assets assigned to the assignee, but rather must submit a proof of claim to the assignee and, if the claim is allowed, will ultimately participate in the assignee’s distribution of funds from the assignment estate.

The option of making an assignment for the benefit of creditors is available on a state-by-state basis. During the meltdown suffered in the dot-com and technology business sectors in the early 2000s, California became the capital of ABCs. In discussing assignments for the benefit of creditors, this article will focus primarily on California ABC law.

**Assignment for the Benefit of Creditors**

As the court has explained, “an assignment for the benefit of creditors is a business liquidation device available to an insolvent debtor as an alternative to bankruptcy proceedings.” Unlike federal bankruptcy proceedings, assignments for the benefit of creditors are governed by state law.

In order to commence the ABC process, a distressed corporation will generally need to obtain both board of director authorization and shareholder approval. While this requirement is dictated by applicable state law, the ABC constitutes a transfer of all of the assignor’s assets to the assignee and the law of many states provides that the transfer of all of a corporation’s assets is subject to shareholder approval (although this approval may be obtained, in some instances, retroactively).²

Assignments for the benefit of creditors in California are governed by common law and are subject to various specific statutory provisions. In states, like California, where common law (with specific statutory supplements) governs the ABC process, the process is non-judicial. The basis for applicability of common law in California is set forth in California Civil Code §22.2 which provides that “[t]he common law of England, so far as it is not repugnant to or inconsistent with the Constitution of the United States, or the Constitution or laws of this State, is the rule of decision in all the courts of this State.”²

An assignee in an assignment for the benefit of creditors serves in a capacity that is analogous to a bankruptcy trustee and is responsible for liquidating the assets of the assignment estate and distributing the net proceeds, if any, to the assignor’s creditors.³

Among the statutory provisions under California law applicable to assignments for the benefit of creditors are the following: (1) Cal. Code Civ. P. §493.010 defining a “general assignment for the benefit of creditors”; (2) Cal. Code Civ. P. §1802 requiring a notice to creditors of the assignment, the setting of a deadline—on 150 to 180 days notice—for submission of claims to the assignee, and setting forth the assignor’s obligation to provide the assignee with a list of creditors, shareholders and other parties in interest; (3) Cal. Code Civ. P. §493.030 providing for termination of attachment and temporary protective order liens obtained within 90 days prior to the making of the assignment for the benefit of creditors; (4) Cal. Code Civ. P. §1204 providing for priority treatment of claims for wages, salaries, commissions and employee benefit contributions; (5) Cal. Code Civ. P. §1204.5 providing priority for consumer deposit claims; (6) Cal. Code Civ. P. §1800 which states the right of assignee to recover preferential transfers—the statute parallels Bankruptcy Code §547 and allows assignee to bring a preference action within one year of the date of the assignment; (7) Cal. Civ. Code §1954.1 establishing the right of assignee to occupy business premises; (8) Cal. Civ. Code §3439.07(d) authorizing assignee to exercise any and all of the rights and remedies available to any one or more creditors of the assignor in connection with bringing a fraudulent transfer action; (9) Cal. Com. Code §6103(c)(6) providing that bulk sales laws do not apply to sales by an assignee for the benefit of creditors; and (10) Cal. Com. Code §§89102(a)(52)(A)(ii) and 9317(a)(2) providing that an assignee for the benefit of creditors and a bankruptcy trustee are each a lien creditor who has priority over an unperfected security interest.

**Advantages of an ABC**

Compared to bankruptcy liquidation, assignments may involve less
administer the liquidation process, in an assignment for the benefit of creditors, the assignor can select an assignee with appropriate experience and expertise to conduct the wind down of its business and liquidation of its assets. In prepackaged ABCs, where an immediate going concern sale will be implemented, the assignee will be involved prior to the ABC going effective.

In situations where a company is burdened with debt that makes a merger or acquisition infeasible, an ABC can be the most efficient, effective and desirable means of effectuating a favorable transaction and addressing the debt. The assignment process enables the assignee to sell the assignor’s assets free of the unsecured debt that burdened the company.

Unlike bankruptcy, where the publicity for the company and its officers and directors will be negative, in an assignment, the press generally reads “assets of Oldco acquired by Newco,” instead of “Oldco files bankruptcy” or “Oldco shuts its doors.” Moreover, the assignment process removes from the board of directors and management of the troubled company the responsibility for and burden of winding down the business and disposing of the assets.

From a buyer’s perspective, acquiring a going concern business or the specific assets of a distressed entity from an assignee, in an ABC sale transaction, provides some important advantages. Most sophisticated buyers will not acquire an ongoing business or substantial assets from a financially distressed entity with outstanding unsecured debt, unless the assets are cleansed either through an ABC or bankruptcy process. Such buyers are generally simply unwilling to subject themselves to potential contentions that the assets were acquired as part of a fraudulent transfer and/or that they are a successor to or subject to successor liability for claims against the distressed entity. Buying a going concern or specified assets from an assignee allows the purchaser to avoid these types of contentions and issues and to obtain the assets free of the assignor’s unsecured debt.

From the perspective of a secured creditor, in certain circumstances, instead of being responsible for conducting a foreclosure proceeding, the secured creditor may prefer to have an independent, objective third party with expertise and experience liquidating businesses acting as an assignee. There is nothing wrong with an assignee entering into appropriate subordination agreements with the secured creditor and liquidating the assignor’s assets and turning the proceeds over to the secured creditor to the extent that the secured creditor holds valid, perfected liens on the assets that are sold.

In many instances involving distressed enterprises, an assignment for the benefit of creditors may be the best means for exiting a business that has reached the end of its lifecycle by minimizing negative publicity, limiting the potential liability of officers and directors and relieving the officers and directors of responsibility for winding down the business and disposing of its assets by entrusting that responsibility to qualified, independent professionals.

Additionally, the ABC process allows buyers of going concerns and specific assets to acquire those assets in an expeditious and efficient manner and at the same time minimize risks associated with the acquisition. Finally, in certain circumstances, the secured creditors may determine that using the ABC process provides advantages compared to pursuing a foreclosure.

Disadvantages of an ABC
Unlike in a bankruptcy case, because the ABC process in California is non-judicial, there is no court order approving a sale by the assignee. As a result, a buyer who requires the clarity of an actual court order approving the sale will not be able to satisfy that desire through an ABC transaction. That being said, the assignee is an independent, third party fiduciary who must agree to the transaction and is responsible for the ABC process. The buyer in an ABC transaction will have an asset purchase agreement and other appropriate ancillary documents that have been executed by the assignee.

Executory contracts and leases cannot be assigned in an ABC without the consent of the other party to the contract (there is no state law equivalent of Bankruptcy Code Section 365). Accordingly, if the assignment of executory contracts and/or leases is a necessary part of the transaction and, if the consent of the other parties to the contracts and leases cannot be obtained, an ABC transaction may not be the appropriate approach. Further, ipso facto default provisions (allowing for termination, forfeiture or modification of contract rights) based on insolvency or commencement of the ABC are not unenforceable as they are in a federal bankruptcy case.

Secured creditor consent is generally required in the context of an ABC. There is no ability to sell free clear of liens, as there is in some circumstances in a federal bankruptcy case, without secured creditor consent (unless the secured creditor will be paid in full from sale proceeds). Moreover, there is no automatic stay to prevent secured creditors from foreclosing on their collateral if they are not in support of the ABC.

Distribution Scheme in ABCs
Under California law, an assignee for the benefit of creditors must set
a deadline for the submission of claims. Notice of the deadline must be disseminated within 30 days of the commencement of the assignment and must provide not less than 150 and not more than 180 days notice of the bar date. Once the assignee has liquidated the assets, evaluated the claims submitted, resolved any pending litigation to the extent necessary prior to making distribution and is otherwise ready to make distribution to creditors, pertinent statutory provisions must be followed in the distribution process. Generally, California law ensures that taxes (both state and municipal), certain unpaid wages and other employee benefits, and customer deposits are paid before general unsecured claims.

Particular care must be taken by assignees in dealing with claims of the federal government. These claims are entitled to priority by reason of a catchall type statute, which entitles the federal government. These claims assignees in dealing with claims of Particular care must be taken by

the bar date.4 Once the assignee has and not more than 180 days notice of the commencement of the assignment, the assignee is liable to the extent of the payment for unpaid claims of the Government.5

As a practical result, these payments must be prioritized above those owed to all state and local taxing agencies. In California, there is no comprehensive priority scheme for distributions from an assignment estate like the priority scheme in bankruptcy or priority schemes under assignment laws in certain other states. Instead, California has various statutes which provide that certain claims should receive priority status over general unsecured claims, such as taxes, priority labor wages, lease deposits, etc. (discussed below). However, the order of priority amongst the various priority claims is not clear. Of course, determining the order of priority amongst priority claims becomes merely an academic exercise if there are sufficient funds to pay all priority claims.

Secured creditors retain their liens on the collateral and are entitled to receive the proceeds from the sale of their collateral up to the extent of the amount of their claim. Thereafter, distribution in California assignments for the benefit of creditors is generally made in accordance with the following priorities: the costs and expenses of the assignment, including the assignee’s fees, legal expenses and costs of administration; obligations owing to the United States (31 U.S.C. §3713); priority wage and benefit claims6 (Cal. Code Civ. P. §1204); state tax claims, including interest and penalties for sales and use taxes, income taxes and bank and corporate taxes (Cal. Rev. & Tax Code §§819253 and 26312); security deposits up to $900 for the lease or rental of property, or purchase of services not provided (Cal. Code Civ. P. §1204.5); unpaid unemployment insurance contribution, including interest and penalties (Cal. Unemp. Ins. Code §1701); State of California, Department of Fish and Game, for all monies owing the State for the sale of licenses and license tags (Cal. Fish & Game Code §1058); and general unsecured claims.10

No distribution to general unsecured creditors should take place until the assignee is satisfied that all priority claims have been paid in full. If there are insufficient funds to pay the unsecured claims in full, then these claims will be paid pro rata. Interest is paid on general unsecured claims only after the principal is paid for all unsecured claims submitted and allowed and only to the extent that a particular creditor is entitled to interest under contract or judgment. If unsecured claims are paid in full, equity holders will receive distribution in accordance with their liquidation rights.

Assignments for the benefit of creditors can be particularly useful when fast action and distressed transaction and/or industry expertise is needed in order to capture value from the liquidation of the assets of a troubled enterprise. The ABC process may allow the parties to avoid the delay and uncertainty of formal federal bankruptcy court proceedings.

In many instances involving deteriorating businesses, management engages in last-ditch efforts to sell the business in the face of mounting debt. However, frequently the value of the business is diminishing rapidly as, among other things, key employees leave. Moreover, the parties interested in acquiring the business and/or assets will only move forward under circumstances where they will not be taking on the unsecured debt of the distressed entity along with its assets. In such instances, especially when the expense of a chapter 11 bankruptcy case may be unsustainable, an assignment for the benefit of creditors can be a viable solution.

2 See, e.g., California Corporations Code §§1001, 151 and 152.
3 See Credit Managers Association of Southern California v. National Independent Business Alliance, 162 Cal. App. 3d at 1170-72. (“Under the common law of assignment, the assignee stands in the place of the assignor…. [A] trustee for all the creditors, [assignee] was charged with the duty to defend the property in its hands against all unjust adverse claims.”); see also In re AB Liquidating, Inc., 18 B.R. 922, 924-26 (Bankr. E.D. Va. 1982).
5 See §§1204 and 1204.5; see also Cal. Rev. & Tax Code §6756.
7 Idem.
8 This section includes all of the following, only to the extent of $4,300, earned within 90 days before the making of the assignment: Wages, salaries, or commissions, including vacation, severance and sick leave pay earned by an individual, sales commissions, unsecured claims for contributions to employee benefit plans. Cal. Code Civ. P. §1204.
9 These tax code sections specifically state that they do not give a preference over any recorded lien which attached prior to the date when the state records or files its lien.
10 The claim of a tenant to any payment or deposit of money the primary function of which is to secure the performance of a rental agreement for other than residential property shall be prior to the claim of any creditor of the landlord, except a trustee in bankruptcy. Cal. Civ. Code §1950.7.

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