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State Court Receiverships and Other Non-Bankruptcy Alternatives[1]

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[1] As with most articles on bankruptcy, this one was built on the foundation created by others including a paper previously presented by Greg Milligan at the Western District of Texas, 2018 Bench Bar Conference and the State Bar Advanced Business Bankruptcy Seminar prepared by Keith Aurzada, Craig Schuenemann and Bradley Purcell, and three articles written for Practical Law by Deborah D. Williamson, Nicholas Zugaro, Alexandria Rahn and Jacob Burkholder – all attorneys with Dykema Gossett PLLC.

Alternatives to Bankruptcy

I. INTRODUCTION

Bankruptcy lawyers are comfortable with our bankruptcy code, forms and procedures. We know our judges, our trustees, and court staff. Bankruptcy lawyers have their own "code" language, including "a 9019", 363 sale and "drop dead" orders.

It has become clear, however, that not every distressed business situation fits neatly into the confines of a bankruptcy filing. Bankruptcy can be costly and, in some instances, result in more harm to clients on both sides of the creditor-debtor relationship.

Today, there are alternatives to bankruptcy. Those alternatives can provide both creditors and debtors with advantages over a traditional bankruptcy filing. Bankruptcy practitioners need to know the alternatives and be able to evaluate whether one of those alternatives would best suit the needs of their client.

II. THE ALTERNATIVES

Bankruptcy is the most obvious means of dealing with a distressed borrower. However, bankruptcy comes with a long list of disadvantages. Bankruptcy tends to be expensive, often prohibitively so in smaller, less complex cases. Bankruptcy cases can take a long time. Subchapter V was designed to mitigate the costs and other barriers, but it is not the perfect panacea.

To reduce the time, expense, or public exposure that is inherent in a bankruptcy filing, practitioners may advise their clients to go another route. Practitioners could consider one of the following alternatives: 1) Wind-down, 2) Composition Agreement, 3) Exchange Offer, 4) Assignment for the Benefit of Creditors, 5) Cooperative UCC Article 9 Sale, or 6) Receivership.[1] Each comes with its own advantages and disadvantages. The goal of this paper is to provide an overview of each alternative, explore advantages and disadvantages, and identify situations where it might be useful to employ a particular alternative.

A. Wind-down

In a wind-down, management makes the decision to cease operations, and liquidate or distribute the business's assets. Put another way, the business ends itself.

The biggest advantage to a wind down is that management controls the process. Management can sell and distribute the proceeds from the business at their chosen pace, with or without the help and cost of professionals. Management can explore multiple sales alternatives, including a public auction or a private sale to individual buyers. Finally, because a wind-down

[1] There are potentially dozens of possible alternatives to bankruptcy that go by different names and are appropriate for specific factual scenarios. These are common alternatives that may be referred to by different names by different practitioners.

does not necessarily involve a legal process, sensitive information about the business or its customers can be protected.[2]

Those same advantages can create risks and uncertainty for both creditors and management. Most businesses that engage in a wind-down do not consult their creditors before undertaking the process. Creditors may not discover the wind-down until it is over, and the business has ceased. Creditors may have no say in either the sale of the assets or the distribution of proceeds. Creditors may initiate a legal proceeding only to find out that the business no longer exists. In a wind-down, there is no mechanism to ensure that the value of assets is maximized or that distribution of proceeds is equitable.[3] On the other side of the equation, management of the entity could begin the wind-down process only to find itself in involuntary bankruptcy, subject to avoidance actions and other complications of bankruptcy. Additionally, under some business structures, such as a general partnership, individual liability may remain after the wind-down is completed.

As a practical matter, wind-down is limited to some very specific situations. One such instance is where the business is close to being solvent, but faces significant future risk. A wind-down allows the management to take advantage of the business's current position to maximize return to its creditors. A wind-down could also make sense for a professional entity such as a doctor's or dentist's office. Patient records and privacy are often a paramount concern, and the transfer of goodwill is a source of value that could be quantified. A bankruptcy is likely to erode or destroy value in such an instance, where a wind-down and sale of the assets by the professional would not.

When evaluating a wind-down, management may have mixed emotions. While it can be easy and less expensive, there is no court-ordered protection for management and insurance issues can arise. Finally, buyers of assets in wind-down may themselves also prefer to purchase assets through a 363 sale process to limit issues with liens, defects in title and future litigation concerning the value of consideration paid.

Consideration of the wind down alternative is even more important in the context of a closely held corporation. It is often ill advised for the corporation or LLC to file Chapter 7 bankruptcy due to the potential for insider exposure such as a review of fraudulent transfers and insider preference claims, especially at a time when the business was insolvent. The look back period under 11 USC § 548 is two years and under the Texas Uniform Fraudulent Transfer Act (TUFTA) can be even longer, allowing a claim, "within four years after the transfer was made or the obligation was incurred or, if later, within one year after the transfer or obligation was or could reasonably have been discovered by the claimant." Tex. Bus. & Com. Code § 24.010(a)(1). These issues, along with the fact that corporations and LLCs don't have exemptions in bankruptcy and are subject to heightened review and investigation by a Trustee, often make a bankruptcy alternative, such as a wind down, the preferred option. This does not mean that the owner of the closely held business

[2] Chatz & Levy, *supra* note 2, at 154.

[3] *Id.*

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