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ALTERNATIVES TO BANKRUPTCY

California Bankruptcy Forum

May 2023

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Bankruptcy Card Counting:

Stay and File? Or Split and Double Down on the Alternatives?

I. <u>ARTICLE 9 SALES</u>

A. <u>Generally</u>

B. <u>The Mechanics</u>

C. <u>Advantages</u>

II. <u>ASSIGNMENTS FOR THE BENEFIT OF CREDITORS</u>

A. <u>Generally</u>

B. <u>Advantages</u>

C. <u>Disadvantages</u>

III. <u>STATE OR FEDERAL RECEIVERSHIPS</u>

A. <u>Generally</u>

B. <u>Mechanics</u>

C. <u>Advantages</u>

D. <u>Disadvantages</u>

IV. <u>OUT OF COURT WORKOUTS OR LIQUIDATIONS</u>

A. <u>Generally</u>

B. <u>Advantages</u>

C. <u>Disadvantages</u>

ARTICLE 9 SALES

A. Generally

Foreclosure sales under Article 9 of the Uniform Commercial Code can be a useful tool when a company is in default on secured debt, reorganization is not feasible, and the lender is willing to be involved in disposition of the collateral.

UCC § 9-610(a) provides that after default (which is defined not by the UCC but by the loan documents) "a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." This gives the lender a great deal of flexibility.

UCC § 9-610(b) provides that "Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms."

B. The Mechanics

The secured creditors must give notice to certain parties of its intention to sell the collateral, and notice must be "a reasonable authenticated notification of disposition." UCC § 9-611(b). Notice must be sent to the debtor, any secondary obligor on the debt, and any other parties claiming a lien against or interest in the collateral. UCC § 9-611-(c). Ten days' notice is sufficient for a non-consumer transaction. UCC § 9-612. The notice must describe the debtor and the secured creditor, the collateral proposed to be disposed, the method of the intended disposition, and must state that the debtor is entitled to an accounting of the unpaid debt, the charge for the accounting, and the time and place of a public disposition.

Proceeds are first used to pay the reasonable expenses of the disposition of the property, including reasonable attorney's fees and legal expenses incurred by the secured party, next to the obligations secured by the collateral, next to junior lienholders if they make a demand for proceeds before distribution of proceeds is completed and, if proceeds remain, to the debtor. UCC § 9-615.

C. Advantages

• Buyers take the assets free and clear of liens, even if the secured party fails to comply with Article 9 (unless the buyer isn't a good faith buyer).

• If done cooperatively, it is a quick and efficient method for disposing of collateral, costing less than a 363 sale in a bankruptcy case and on a shorter timeline.

• The foreclosure is not public, so if the foreclosure does not involve all assets and the company remains an ongoing operation, it may avoid damage to its reputation because unsecured creditors do not have to be notified.

• If, and only if, the foreclosure it conducted publicly, a secured party can bid for the assets using its credit.

D. Disadvantages

• Private sales are generally discouraged and put the onus on the secured party to establish the value. 9-610(c)(2) states that a private disposition is available "only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations."

• Sale must be commercially reasonable or the secured creditor risks liability. Commercial reasonableness is not a clear standard.

• Diligence is limited to Debtor's cooperation.

• Asset transfer can be complex depending on cooperation and type of asset.

ASSIGNMENTS FOR THE BENEFIT OF CREDITORS

A. Generally

Every state has some form of an assignment for benefit of creditors, which is essentially a liquidation under state law. In some states, it is judicially supervised but in others (like California), it is not. A company assigns all of its assets to an assignee, which accepts them, liquidates them, and then distributed proceeds to creditors.

Assignments are not a vehicle for a reorganization and are instead only used in liquidations. Assignees are inherently risk adverse and will operate a business for only a short period of time if they can ensure that the benefits will exceed the costs of doing so and it is necessary to preserve value. Many times, sales of the assets are teed up in advance of the actual assignment so that the assignment and the sale occur virtually simultaneously. Other times, the assignee may run a sale process once the assignment occurs.

Much like in a bankruptcy, proceeds are used to pay secured creditors with valid liens against the collateral, and then priority debts such as taxes and wage claims, and then to trade creditors. There is a claims process similar to a bankruptcy proceeding.

B. Advantages

• Avoids the expense and scrutiny of a chapter 7 trustee.

• It's a more efficient and expeditious way of liquidating a business.

• In some states (including California), the assignee may have the ability to recover preferential payments in the ninety days prior to the assignment and fraudulent transfers made by the assignor. However, if under federal jurisdiction, *Sherwood v. Lycos* prevents preference litigation as preempted by bankruptcy law. The California Supreme Court in *Credit Managers Assn. of California v. Countrywide Home Loans, Inc.* 144 Cal. App. 4th 590 (4th Dist. 2006) faced the same analysis and found that no preemption exists.

C. Disadvantages

• If a secured creditor is involved, the assignee either needs to be comfortable that the value of the assets exceeds the secured debt, or the secured creditor must consent in advance to the assignment and subordinate its lien to the administrative expenses of the assignment estate.

- There is generally no automatic stay, so litigation against the company that is the subject of the assignment can continue. However, there are no assets which can be attached after default.

- If property is in multiple jurisdictions, an assignment may not be the best avenue because the assignment might not include property in other jurisdictions which would instead be the subject of the laws of the state in which the property is located.

- Creditors dissatisfied with the process can file an involuntary bankruptcy at which point the Court can abstain, dismiss or choose to exercise jurisdiction.

- The sale does not have the force of a federal court order authorizing the sale free and clear of liens.

- There is no discharge of debt as there might be in a liquidating chapter 11 where there are some limited business operations after confirmation of the plan.

- There is no cap on certain claims, like lease rejection damages.

STATE OR FEDERAL RECEIVERSHIPS

A. Generally

A receiver is a neutral fiduciary whose powers and responsibilities are defined by the documents or order appointing them. They are almost always judicially appointed. Receivers are not appointed in the interest of the company but are instead appointed in the interests of creditors or shareholders, who are the parties with authority to seek appointment of a receiver.[1]

The scope of the duties of a receiver are typically defined by the appointment order, and the receiver is an officer of the court.

Where there is federal jurisdiction, a federal court may appoint a receiver after taking into consideration the following factors: (1) existence of fraudulent conduct, (2) the validity of the claim of the party seeking the appointment, (3) whether there is an imminent danger that assets will be lost, damaged, dissipated, or decreased in value, (4) the inadequacy of alternative remedies, and (5) the likelihood that a receiver will do more good than harm. *See Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc.*, 999 F.2d 314, 316-17 (8th Cir. 1993).

B. Mechanics

Typically, an action to appoint a receiver is initiated by litigation brought by either (1) a secured creditor whose contracts authorizes it to seek a receiver as one of the remedies for default, (2) a creditor where collateral is at risk of being dissipated or not maintained or the business is being mismanaged and assets dissipated, or (3) by shareholders who file an action to dissolve a corporation and seek the appointment of a receiver to assist in that process, typically because of a dispute between the shareholders. It can also be a post-judgment enforcement remedy. The receiver is generally appointed to take over control and management of property that is the subject of litigation before the court. It is an ancillary remedy, not an independent action. A receiver appointed to take possession of and satisfy creditors from the debtor's assets is referred to as a general or equity

[1] Federal regulatory receiverships have different characteristics and are not discussed in these materials.

receiver; a receiver appointed over specific collateral is a custodial receiver, also referred to as a rents and profits receiver.

The scope of a receiver's duties depends on the relevant statutes and largely on the appointment order. It is critical that the appointment order lists the specific duties of the receiver and which actions the court authorizes the receiver to take to perform those tasks and whether further court approval is required. Ideally, it should also impose a stay against any actions by third parties that may affect the receivership property.

Receivers have the right to take and keep possession of all receivership property but may dispose of it only by court order and according to the directions of the court. They serve until performance of their duties is complete or the litigation out of which their appointment was made has been resolved.

C. Advantages

• Can be used not just to liquidate or wind down a business but, in certain circumstances, to reorganize or stabilize a business. It is a very useful tool for closely held corporations with disagreements between owners on major business decisions.

• If real property is involved and for any number of reasons, the debtor is having difficulty obtaining loans to address issues at the real property that are required to preserve or increase value, receivers in most states have the ability to issue "certificates of indebtedness," also known as receiver's certificates, to lenders who extend further credit and to give them a priority claim against the property.

•It is typically less expensive than a chapter 11 because there are fewer procedural requirements than a chapter 11 case and fewer parties involved.

• Because cannabis companies cannot yet avail themselves of the protections of the Bankruptcy Code, state court receiverships are often the only option for reorganization or a liquidation.

D. Disadvantages

• State courts typically only have jurisdiction over property located within the state, so a company with assets in multiple states may not be the best candidate because ancillary receiverships will be required in other states. Federal courts can exercise jurisdiction over assets in other states as long as a notice of receivership is filed in the other jurisdictions within a specified time frame. *See* 28 U.S.C. § 754.

• If transparency is the goal, receiverships are less transparent than bankruptcy cases because there is no requirement that a debtor file a schedule of assets or liabilities or a statement of financial affairs, and state court pleadings may not be as readily available as federal filings are.

• Unless the receivership order provides that only the receiver may initiate a bankruptcy filing, the appointment of a receiver may drive a company into a bankruptcy filing. Another way to prevent a bankruptcy filing may be to have the appointment order give the receiver the sole authority to pick a new board of directors for the corporation. If the receiver does so, then the directors who are replaced have no authority to initiate a bankruptcy case. *See Sino Clean Energy, Inc. v. Seiden (In re Sino Clean Energy, Inc.),* 901 F.3d 1139 (9th Cir. 2018).

• Even if the state court receivership order contains a provision staying litigation, that may not be enforceable by a creditor taking action in a different state, and that creditor may not be forced to deal with its claim in a single forum as it would if a bankruptcy case were filed.

• Receivers may not have the authority to assume, assign or reject executory contracts as one would in a bankruptcy case, and a receiver may not be able to recover preferential payments.

• There may be limitations on the receiver's ability to sell assets free and clear of liens, claims, and encumbrances.

OUT OF COURT WORKOUTS OR LIQUIDATIONS

A. Generally

Typically, an out of court workout or liquidation involves a contractual agreement with a secured creditor or core group of creditors to restructure obligations by consent. It may involve an agreement to voluntarily discharge the remaining debt after certain payments are made. It can involve other cost-cutting measures, such as reducing overhead or obtaining new financing.

B. Advantages

• Typically less expensive than a chapter 11 or 7.

• It is not subject to the publicity or transparency of a bankruptcy case.

• Typically more efficient than a chapter 11.

• Avoids the expense and scrutiny of a chapter 7 trustee (which may be a disadvantage for creditors).

C. Disadvantages

• It is not a practical solution if creditors are adversarial and not interested in coming to the table, nor is it a practical solution if there are a large number of trade creditors such that the logistics of reaching an agreement with them is unwieldy.

• Does not involve the transparency of a bankruptcy case and is not overseen by a fiduciary appointed by the court or the Office of the United States Trustee, and avoidance actions are not pursued.

• There is no ability to reject leases, so if a key factor in the successful restructuring is rejection of leases, this may not be a viable option.

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Since launching his career at Danning Gill, Mo has become an active member of the bankruptcy bar. Aside from being published in the California Bankruptcy Journal, he also sits as the chair of the Beverly Hills Bar Association's bankruptcy section and the co-chair of the Los Angeles Bankruptcy Forum's Diversity, Equity, & Inclusion committee. Most recently, Mo has been honored at the National Conference of Bankruptcy Judges as a recipient of the 2022 Blackshear Fellowship, named after the Honorable Cornelius Blackshear

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Benjamin King is a commercial litigator and creditors' rights attorney who has particular expertise in protecting creditors' interests through the use of prejudgment remedies such as attachment, receiverships, and injunctive remedies. He has represented national financial institutions, a number of California lenders, and receivers in, among other matters, actions involving the exercise of loan remedies, workouts of troubled loans, and actions for foreclosure upon loan collateral. Benjamin has litigated matters on behalf of creditors in both pre-bankruptcy and bankruptcy contexts, including lender liability actions, real-estate loan disputes, contract disputes, judicial foreclosures, receivership actions, fraudulent conveyance matters, adversary proceedings (including preference actions), non-dischargeability actions, and a variety of business tort disputes.

In addition to his representation of lenders, other creditors and receivers, Benjamin has represented firm clients in a variety of litigation matters including, among other things, class actions, unfair trade practices disputes, FTC actions, Lanham Act claims, copyright disputes, and publicity rights lawsuits. He has developed particular expertise assisting firm clients in ensuring that their websites are accessible to disabled persons in compliance with the requirements of the Americans with Disabilities Act.

Benjamin's pro bono efforts include work for Children's Rights, a national organization that utilizes class action lawsuits and other methods to affect positive change for abused and neglected children and to bring much needed reform to state foster care systems.

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Kyra E. Andrassy is a partner of Smiley Wang-Ekvall, LLP. She concentrates her practice on bankruptcy and insolvency matters and business litigation. Her insolvency-related work includes representing chapter 11 debtors, chapter 7 and chapter 11 trustees, secured and unsecured creditors, creditors' committees, purchasers of assets from bankruptcy estates, assignees in assignments for the benefit of creditors, federal and state court receivers, and borrowers in out-of-court workouts. Ms. Andrassy's business litigation practice includes a broad range of disputes in state and federal court, including breach of contract and fraud.

She received her undergraduate degree in political science from the University of California at San Diego in 1995, and her law degree from Loyola Law School in Los Angeles in 1998. She was an editor of the *Loyola Law Review* and the recipient of the American Jurisprudence Book Award in Legal Writing. She served a judicial externship to the Honorable Barry Russell, United States Bankruptcy Judge for the Central District of California, in Spring 1998. From September 1998 until September 2000, Ms. Andrassy served a judicial clerkship to the Honorable John E. Ryan, United States Bankruptcy Judge for the Central District of California and a member of the Ninth Circuit Bankruptcy Appellate Panel.

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Jake DiIorio, a focused project manager and financial analyst, is instrumental in resolving complex turnarounds and loan workouts for business and real estate engagements. He applies deep experience in forensic accounting, business valuation, operations and asset disposition to manage projects ranging from solvency analyses to comprehensive receiverships and chapter 11 restructurings. Jake provides clients with key reports throughout the process to facilitate informed decisions.

Prior to joining the Stapleton Group in 2010, Jake was a senior auditor at Ernst & Young in New York, NY. In this position, he consulted to Fortune 500 companies in multiple industries, specializing in valuation analysis.

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Molly Froschauer is an insolvency professional with nine years of experience in bankruptcy and with companies in distress. Before joining Sherwood, she practiced as a bankruptcy attorney and served as the general manager of an out-of-court insolvency service-provider and liquidation agent. She also managed meetings for trade creditors, advocated for out-of-court business debt solutions and educated trade creditors on their options for businesses resolving their debt.

Molly was an editor of the Manual of Credit and Commercial Laws published by the National Association for Credit Management. There, she managed over fifty Assignments for the Benefit of Creditors, out-of-court workouts and engagements though the bankruptcy court.

Molly attended Claremont McKenna College where she graduated with a double major in International Relations and French. She then attended Pepperdine Law School where she graduated cum laude and was a member of the Law Review. While still in school she worked in federal district court for the Honorable Judge Gutierrez and in the European Union's Assembly of Regions.

Molly is a member of several insolvency professional organizations and has given talks for the Turnaround Management Association and the National Association for Credit Management on alternatives to commercial bankruptcy.

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Veronica Rocha is a Director with Arch + Beam and brings over 15 years of experience in management, operations, and finance. She has worked on many consulting engagements related to financial distressed companies, Chapter 11 bankruptcies, liquidations and real estate holdings.

Her earlier career ranged from commercial operations across the Americas and Europe to consultant roles in private equity. With a deep analytical foundation, she has expertise in operations management, strategy development and execution, and operational and financial analysis.

An advocate of data driven management decisions, Veronica thrives in dynamic, complex environments with a focus on continuous improvement and business success. Exceptional analytical skills and project management skills were developed during an early career in scientific research at NASA Ames Research Center and San Jose State University, followed by work in product and operations management in the biotechnology, pharma, and renewables industries.

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