

CREDITOR'S RIGHTS TOOLKIT

What Is an Assignment for the Benefit of Creditors and How Does It Differ From a Bankruptcy?

An assignment for the benefit of creditors (ABC) is a 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). The assignee is responsible for liquidating those assets and distributing the proceeds to the assignor's creditors, pursuant to the priorities established under applicable law. From the perspective of a creditor, there are many important distinctions between an ABC and a bankruptcy case.

Key Issues

- **NONCOURT SUPERVISED ABCS**

Unlike a bankruptcy, which is governed by federal law, an ABC is based on state law. ABCs are court supervised in certain jurisdictions (e.g., Delaware, New Jersey, and Florida) and are merely statutory in other jurisdictions (e.g., California). In jurisdictions where there is no court oversight, there will be no docket, making it more challenging for a creditor to get information on the ABC.

- **IPSO FACTO CLAUSES ARE ENFORCEABLE**

Ipso facto clauses, which are common in many contracts, provide that a contract will terminate upon the occurrence of an insolvency event. In a bankruptcy proceeding, unless certain exceptions apply, ipso facto clauses are not enforceable. However, in ABCs such provisions are enforceable, thus giving a contract counterparty the ability to simply terminate a contract once the ABC is commenced.

- **NO AUTOMATIC STAY**

Immediately upon filing for bankruptcy, an automatic stay goes into effect pursuant to Section 362 of the Bankruptcy Code. The automatic stay is intended to give the debtor breathing room and prevents creditors from taking action against the debtor to collect on amounts owed to them. In general, there is no automatic stay in an ABC, although some states do have a version of Section 362 incorporated into their state law. A creditor should consult with experienced counsel before taking action against a company that has commenced an ABC to avoid violating any state law version of Section 362, which could lead to sanctions against the creditor.

- **ANTI-ASSIGNMENT CONTRACT PROVISIONS ARE ENFORCEABLE**

Except for limited situations, anti-assignment provisions in a contract, which prohibit the assignment of a contract without the consent of the contract counterparty, are not enforceable in bankruptcy. However, such provisions remain valid in an ABC. Because the contract counterparty must agree to accept the purchaser of the assignor's assets as the new obligor under the contract, the contract counterparty has significantly more leverage in an ABC compared to a bankruptcy.

- **NO ABILITY TO SELL FREE OF LIENS**

Unlike a bankruptcy sale, the assignee cannot sell assets "free and clear" of liens without the consent or full payoff of lienholders. Thus, secured parties must agree to the sale if they are not going to receive full payment from the sale proceeds. Otherwise, the purchaser takes the assets subject to the secured parties existing liens.

- **PREFERENCE CLAIMS MAY NOT EXIST**

Different states have different rules regarding the ability of the assignee to reclaim funds paid out to creditors in the period prior to the ABC being effectuated, similar to a preference claim brought pursuant to Section 547 of the Bankruptcy Code in a bankruptcy case. For example, whereas New Jersey has a statute that allows for the claw back of certain funds, Delaware does not have such a statute. Even in states where preference actions are permitted, the elements necessary to prove a preference claim and the defense available to such claim may not be the same as in a bankruptcy case so a creditor who gets sued for a preference in an ABC should not assume that the rules of Section 547 apply.

- **INVOLUNTARY BANKRUPTCY CASE**

There may be times when creditors believe that the company should be liquidated under federal bankruptcy law rather than via an ABC. For example, if the ABC was commenced in bad faith to avoid preference liability for insiders or where the assignee is not a third-party independent fiduciary but acting at the direction of the assignor, creditors may seek to have the company put into an involuntary case notwithstanding that the ABC has been effected. However, there can be risk to a creditor who improperly seeks an involuntary bankruptcy with a company.¹

- **DEADLINE TO FILE CLAIMS**

Similar to a bankruptcy, the assignee will establish a deadline for creditors to file claims. Any claim not timely filed will not share in the proceeds of the ABC. Unlike a bankruptcy, there are no schedules in an ABC so any creditor who is owed money by the assignor must file a claim.

Takeaway

Because they are creatures of state law, ABCs vary across the U.S. ABCs are not simply bankruptcy cases under state law. The differences can provide creditors with leverage that may not exist in a bankruptcy. It is important to consult with experienced counsel when involved in an ABC.

¹ See [What Is an Involuntary Bankruptcy and How Can Creditors Use This Powerful Tool?](#)