

5 Issues to Consider When Liquidating Through an ABC

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Assignments for the benefit of creditors, or ABCs, continue to grow in popularity as a tool for the orderly wind-down of companies.

From the perspective of the company and its officers and directors, there are numerous reasons that an ABC is an attractive option for winding down a company.

First, an ABC costs substantially less than a Chapter 11 case and can be effectuated in a short period of time.

Second, in most cases, directors and officers of a company resign at the time the ABC is effectuated, allowing them to move onto other opportunities while the assignee takes responsibility for winding down the company.

Third, unlike a bankruptcy filing which often becomes front page news resulting in negative publicity for the company and its directors and officers, there is very little, if any, publicity in connection with an ABC.

Fourth, directors and officers often are concerned that a hostile Chapter 7 trustee — who is appointed by the bankruptcy court — might try to bring claims against them to fund the bankruptcy case, compared to an ABC process where the company gets to select the assignee and work cooperatively with the assignee in advance of effectuating the ABC.

While many articles have examined the general process of an ABC and the pros and cons of an ABC compared to other liquidation options, this article focuses on certain key issues that the company and its officers and directors should consider prior to deciding to effectuate an ABC.

1. Carefully exercise fiduciary duties.

In general, under Delaware, law directors and officers owe fiduciary duties, including the duty of care and the duty of loyalty.

Together, these duties require directors and officers to make decisions, in good faith and after reasonable

diligence, that are in the best interests of the company and not their own personal interests.

When a company is solvent, directors and officers owe their fiduciary duties to the company and its shareholders. When a company is insolvent, directors and officers owe their fiduciary duties to all residual interest holders, including creditors.

Deciding to effectuate an ABC to ensure the orderly wind-down of a company is one way a board can fulfill its fiduciary duties, since the ABC process ensures assets are liquidated and the proceeds distributed to creditors pursuant to the priorities established under applicable law and because the assignee in and of itself is a fiduciary to the assignor's creditors.

However, the right course of action to be undertaken is highly fact intensive and the board must carefully consider all viable options in the exercise of its fiduciary duties prior to deciding an ABC is the proper way to liquidate.

Unfortunately, too many companies wait until the last minute to engage insolvency counsel and there simply is not sufficient time or funds to consider whether an ABC is the proper course of action.

As such, it is critical that the board work with a financial advisor to prepare a 13-week cash flow, so the board understands the company's cash situation and can ensure payment of required amounts, as further discussed below.

The board should engage in good faith discussions focused on the value and benefit to creditors to be achieved as a result of different liquidation options and should ensure that those making the decisions are conflict free, so any path forward is not tainted by improper self-dealing.

The actions of the board are often viewed with 20/20 hindsight. As such, it is critical that the board minutes reflect the process the board undertook and the reasons for its actions.

By doing so, the board minutes will reflect the efforts the board undertook to fulfill its fiduciary duties.

2. Consider in which state to effectuate the ABC.

Although ABCs are a creature of state law, parties often look to the U.S. Bankruptcy Code when determining where a company can effectuate its ABC, such as where the company is incorporated or the location of the company's principal place of business.

Additionally, some assignees take the position that as long as the assignee is incorporated in the applicable state or has its principal place of business in such state, the venue requirement is met.

Whereas in some states, ABCs are done under the purview of the court, such as in Delaware, Florida and New Jersey, in other states, ABCs are out of court proceedings, such as California.

If the assignor and assignee expect difficulty from certain of the company's constituents, having the ability to seek relief from the court may be an important factor in determining whether to effectuate the ABC in a jurisdiction

where the ABC is conducted under court supervision.

Additionally, in certain types of cases, a proposed purchaser of the company's assets may want the comfort of a sale order from a court, which will dictate that the ABC be commenced in a jurisdiction where court oversight is mandated.

Moreover, 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 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.

If significant amounts of funds were paid out prior to the ABC being effectuated, the potential to claw back funds may factor into the decision about the venue of the ABC.

This is especially true in cases where there is no secured creditor or where there is expected to be funds to distribute to unsecured creditors, since the ability to claw back funds will help to ensure equality of distribution among the company's general unsecured creditors.

3. Ensure payment of certain taxes and employee wages.

Prior to effectuating an ABC, directors and officers of the assignor will want to ensure that all trust fund taxes are paid in full. Trust fund taxes are funds collected by the company in trust for the benefit of the government.

Examples of trust fund taxes include sale taxes, excise taxes, and certain payroll taxes. Individuals who are responsible persons for collecting and paying these taxes and willfully fail to do so can be held personally liable — and in some cases criminally liable — for the full amount of the tax.

Moreover, Title 31 of the U.S. Code, Section 3713, requires an insolvent company not in bankruptcy to pay the claims of the federal government prior to paying any of its other unsecured creditors and that directors and officers of the company can be held personally liable to the government for unpaid amounts.

Additionally, prior to effectuating an ABC, it is important to make sure that all wages are paid as unpaid wages also can result in personal — and in some instances criminal liability.

As part of its due diligence process, the company should undertake a careful review of the policies and procedures governing amounts owed its employees including any employment agreements, severance agreements, bonus policies, employee handbooks, etc.

It is important to be aware that what constitutes wages varies from state to state. For example, in some states, severance bonuses constitute wages.

Moreover, the company should carefully consider whether the anticipated termination of employees in connection with the ABC will trigger the Worker Adjustment and Retraining Notification Act and similar state laws, which require employers of a certain size to provide workers with at least 60 days advance notice of a plant closing or

mass layoff.

4. Obtain D&O tail coverage.

Another important step to undertake prior to effectuating an ABC is to obtain a directors and officers tail policy.

A tail is an extension of the D&O policy that allows the directors and officers to continue reporting claims to the insurance company once the D&O policy expires or terminates. The tail policy ensures directors and officers are protected from claims that occurred prior to the time the policy terminated.

As the cost of the tail must be paid in full when the tail policy is obtained, this is something that should be included in the 13-week cash flow budget that the company prepares in connection with the wind-down.

5. Prepare a broad creditor mailing list.

As part of the ABC process, the assignee will set a deadline for creditors of the assignor to assert claims.

Creditors who do not timely file a claim do not receive a distribution in the ABC and their claims are considered discharged against the assignor. As such, it is critical that the assignor take the time to prepare a detailed creditor mailing list that captures all known creditors as well as potentially unknown creditors.

For example, the list should include all customers, vendors, contract and leases parties, litigation parties, employees and consultants, professionals, etc.

Additionally, it is important to include all taxing authorities, both at the county, state and federal levels, as well as regulators.

Takeaways

An ABC may be the right means of winding down the affairs of a company.

However, prior to deciding to effectuate an ABC, there are important steps a company and its board should take in the exercise of its fiduciary duties, to protect its directors and officers and to ensure the overall goals of the ABC are achieved.

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