Admin. November 7, 1996

Third Supplement to Memorandum 96-58

New Topics and Priorities: Topics Suggested by Commissioner Wied

Attached to this supplemental memorandum is a letter from Commission Member Colin Wied with several suggested topics for Commission study.

Extend Application of Chapter 9 of Bankruptcy Code

Commissioner Wied indicates that the new Bankruptcy Code extends considerable latitude to state and local governments to choose whether to final a Chapter 9 petition (adjustment of debts of governmental entities). He notes that existing law dates back to the 1940s and fails to take advantage of this latitude.

He also suggests that Chapter 9 might be extended to nonprofit corporations that administer government funded programs. Chapter 9 may offer greater advantages to these quasi-public entities than Chapter 11 (reorganization).

Codify and Expand Law Governing Assignments for Benefit of Creditors

Commissioner Wied recommends comprehensive legislation governing assignments for benefit of creditors, observing that existing statutory law is sparse and case law adds little. The staff agrees with this assessment, but notes that the Commission began just such a project 17 years ago, and the staff actually completed a draft comprehensive statute. The Commission ended up abandoning the project on advice from the credit managers' associations and boards of trade that they would vigorously opposed "government regulation" of assignments. Instead, we recommended repeal of the old obsolete assignment statute; that repeal was enacted by the Legislature.

Commissioner Wied also suggests extension of the assignment concept (liquidation) to reorganization. Current Chapter 11 reorganization is an inadequate vehicle for small to medium-large businesses.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

C.W. WIED PROFESSIONAL CORPORATION
501 WEST BROADWAY, SUITE 1780
SAN DIEGO, CA 92101

COLIN W. WIED
TELEPHONE: (619) 338-4030
FACSIMILE: (619) 338-4022

DIRECT DIAL NO.
(619) 338-4024

November 6, 1996

Via Facsimile

Nathanial Sterling, Esq.
California Law Revision Commission
400 Middlefield Road, Suite D2
Palo Alto, CA 94303-4739

Re: Studies of (1) Proposed Legislation Respecting Implementation of 11 U.S.C. Chapter 9; and (2) Comprehensive Review and Revision of Laws Respecting General Assignments for the Benefit of Creditors

Dear Nat:

I propose that the Commission undertake two projects, one very small, and the other considerably larger in scope.

The first proposal is to bring California Law current with respect to implementing Chapter 9 of Title 11, United States Code. Current law dates back to the 1940s and relates to the old Bankruptcy Act, which was completely changed by the current Bankruptcy Code (11 U.S. Code) which became effective on October 1, 1979. Chapter 9 provides for the "adjustment of debts" of governmental entities. It has some similarity to (but many differences from) Chapter 11. The Bankruptcy Code extends considerable latitude to state and local governments to choose whether to file a Chapter 9 petition. 11 U.S. C. Sections 109(c) and 101(40). Current state law does not take advantage of it.

It would be worthwhile, in connection with this study, to consider extending the application of Chapter 9 to non-profit corporations that administer government funded programs. I just completed a reorganization of such a company under Chapter 11. It would have been much better, from the standpoint of both the federal and state governments, if this case could have been handled in Chapter 9. One reason is that the federal government contends, with support in the Seventh Circuit, that property bought with federal grant money belongs to the federal government, notwithstanding liens of record and the fact that the government rarely appears on title, either as to personal or real property. Another reason is that many such non-profit organizations must qualify as Community Action Agencies, which are defined and governed by

Cal. Gov. Code Sections 12,750 et. seq. The third reason is the obvious one: these companies are, in reality, governmental agencies. Current California law makes it difficult, if not impossible, for such companies to file under Chapter 9. The regulatory state agencies are simply unaware of the extent to which their interests may be impacted in a Chapter 11. If fully informed, they would probably conclude it to be in their interest to be able to authorize Chapter 9 filings by the agencies which they fund.

The second proposal would involve considerably more study, and would be of considerable interest to the insolvency community, including especially institutional lenders, reorganization attorneys and turnaround/workout specialists. My recommendation is two-pronged.

First, current law respecting General Assignments for the Benefit of Creditors (GABC) is ill defined. A GABC creates a trust, but there are no generally applicable statutory trust provisions. (Probate trust law is specifically inapplicable.) Statutory law is far from comprehensive, and case law adds little. For example, no statute sets out the priority of payment of claims. Assignees typically follow the priority set out in the Bankruptcy Code (11 U.S.C. Section 507), hoping no one objects. GABCs take place frequently, and are favored as a private, speedy and less costly business liquidation, as opposed to the more costly, time consuming and relatively ineffective Chapter 7 (11 U.S. Code) liquidation. They are handled, for the most part, by less than a half dozen companies in California. The assignee under a GABC is given some of a bankruptcy trustee's avoiding powers. It would be worthwhile to study whether interested parties would like a clarification and codification of GABC law.

Second, it would be worthwhile to study whether the GABC concept could be extended from simply liquidation (a Chapter 7 substitute) to reorganization (a Chapter 11 substitute). The entire insolvency community will acknowledge that Chapter 11 is not an adequate means of reorganization of small to medium large (i.e., non-public) businesses. It is too complicated, and it was made that way intentionally. Congress reasoned that if no party to a Chapter 11 had a clear shot, all parties would be compelled to negotiate. In practice, the reverse has happened. Bankruptcy litigation is a growth industry for lawyers, accountants and other professionals. The administrative cost of any Chapter 11, by itself, precludes successful reorganization of most companies. Chapter 11 success rate is abysmal - less than 10% of the cases result in confirmed plans, and only half of those fully perform the confirmed plan. Added to the low rate of plan confirmation is the enormous cost in money and time to creditors.

It is true that many companies that file Chapter 11 are "dead on arrival," and should never have filed Chapter 11. Of those that are viable, usually such a high level of mistrust exists between the debtor and its creditors that a reorganization plan cannot be negotiated before escalating administrative costs (i.e., attorneys' fees which must be paid in full before a plan can be

confirmed) doom the reorganization to failure. I have found that retaining an independent, respected turnaround/workout consultant to make an initial assessment of the company's viability and to recommend what steps should be taken to turn the business around, is money well spent. The consultant can help eliminate the mistrust of the debtor and lack of creditor confidence in the business of the debtor, thus paving the way to earlier, less costly reorganization.

English and Canadian law recognize the need for independent experts. American bankruptcy law does not. Even when U.S. Bankruptcy Courts order the appointment of trustees (the United States Trustee makes the appointment), the appointees rarely have any particular reorganization expertise. I have become convinced that some independent, reliable expertise is necessary if impediments to business reorganization are to be avoided.

States are Constitutionally precluded from enacting bankruptcy laws. Obviously, this does not foreclose GABCs under state law, which are really private Chapter 7s, for no discharge of debt follows from a GABC. So long as debt is not discharged, I see no reason why the scope of a GABC could not be expanded to include reorganization. All that would be required initially would be to enable the assignee under GABC to investigate and report to creditors on the viability of the company, and the steps to be taken to restore profitability; and then to advise and assist the debtor and creditors in formulating and negotiating a reorganization plan. Most of what the assignee would do would be with the consent of the creditors, and, for that matter, the debtor as well. At any time, a voluntary or involuntary petition under Title 11 could be filed by the debtor or creditors, thus terminating the GABC. If a high level of confidence in both the assignee and the debtor can be established early on, there is no reason why the business turnaround and reorganization cannot be quickly and economically accomplished.

The assignee under a GABC acquires legal title, in trust, to the debtor's assets. The assignee needs clear authority, which now does not exist, to continue the operation of the business at the debtor's expense. It also needs to be able to deal with executory contracts and leases (to preserve them for the benefit of the estate), and with secured creditors in order to preserve the debtor's equity in secured property for the benefit of the estate. The extent to which an assignee under a GABC should be given such authority will be a matter in which various groups (e.g., lenders, lessors) will have a keen interest. The inducement to all interested groups to accept and work within a private (i.e., state sanctioned) reorganization scheme is a great savings in time and expense. Considering the aggravation creditors now suffer in Chapter 11, I believe an expanded GABC law could be devised that would be embraced by them.

It is important to note that the assignee would take the place of a creditors committee (and the professionals typically hired by it at the expense of the estate), as well as the U.S. Trustee. While there would be a cost for using an assignee, it would probably be markedly less than the combined administrative costs in the typical Chapter 11.

Essential to the idea of expanding the scope of the GABC is the creation of a recognized profession consisting of business turnaround/reorganization experts. Such professionals would be business people, not necessarily accountants or lawyers. These professionals now exist, although for a variety of reasons they are infrequently used in non-public cases. A means will have to be devised for qualifying and certifying those who would become assignees under the expanded GABC.

I will be providing copies of this letter to some highly qualified business turnaround/ workout companies for their comment, as well as to some California companies that regularly act as assignees under GABCs. If there is interest in the idea, perhaps the Commission would want to constitute an advisory group of consultants. I believe such a group could be formed at no cost, for it should be in the pecuniary interest of all groups to help advance this concept.

I look forward to discussing these undertakings with you and the Commission.

Very truly yours,

Colin W. Wied

CWW/slg