Points to Consider When Implementing an Extension Plan in Bankruptcy

Under an extension plan in a bankruptcy case, the debtor proposes to pay creditors in full over a period of time. In effect, an extension is a deferral of payment of debts. The debtor remains in possession and continues to operate the business and buys on a cash basis temporarily. The creditors' committee acts in an advisory capacity only and does not assume active control of the business. Obviously, an extension requires an optimistic prospect of future operations.

Creditors should make sure that adequate controls are instituted for the operation of the business and, in the event rehabilitation is not possible, over the liquidation of assets and disposition of the proceeds. This provides reasonable assurance that assets are protected from improper use and produces records from which reliable reports can be prepared. Ways for exercising this control are described below.

Assignment for the Benefit of Creditors

One technique assumes that the business in effect belongs to the creditors. The creditors' committee may request or insist that the debtor execute an assignment for the benefit of creditors to be held in escrow by the committee. If the debtor defaults in performance of extension payments, the assignment becomes effective. The assignee may then liquidate the assets for the benefit of all creditors.

Transfer of Stock

This is effective when the debtor is a corporation. In addition to the assignment, or as a substitute, the creditors' committee may have the stockholders transfer their stock certificates to the committee or to an adjustment bureau to be held in escrow. If the extension plan is fully performed, the shares are returned. If not, the transfer becomes effective and the entire corporation becomes the property of the committee to be liquidated for the benefit of creditors.

The committee may also receive and hold in escrow the written resignation of all officers and directors of the debtor corporation. The committee will thus be in a position to assume complete ownership and control if the debtor defaults under the plan.

Financial Controls

During the extension periods, the committee may designate that its accountant monitors or, if necessary, supervises operations or has a representative countersign all checks and control expenditures.

Security

When using an extension plan, the debtor presumably will execute extension notes to the creditors, payable in installments. In addition, the creditors' committee may request or demand some form of security for payment.

The form of security may include the following:

- A mortgage on the debtor's real estate, which is frequently owned by the debtor and spouse
- A security interest in accounts, inventory and other assets of the debtor
- An assignment of accounts receivable
- A guarantee of the extension notes by a responsible third party acceptable to the committee

A security interest in accounts, inventory and other personal property must be perfected under the Uniform Commercial Code (UCC).

New Trade Creditors

To obtain the cooperation of new trade creditors, a security interest under the UCC could be given to creditors with the old debt, and they in turn could subordinate that debt to the new trade creditors to give them a priority and thus encourage shipments to the debtor.

This type of arrangement has to be fully documented, and comply with the UCC with respect to the lien and the subordination. It is widely used in rehabilitation cases and gives a good measure of flexibility in working out problems.

Source: NACM's *Principles of Business Credit*