

Alternatives to Bankruptcy: A Primer on Composition Agreements

By Thomas Lindahl

In the current economic climate, business attorneys are increasingly faced with situations where a client or an opposing party is either insolvent or suffering from financial distress. It is axiomatic that the business of a debtor will be paralyzed if its bank accounts are frozen by a garnishment or the assets of a company are seized in an execution.

The most recognized course of action for such a debtor is filing for bankruptcy under chapter 11 of the Bankruptcy Code to reorganize (or under chapter 7 of the Bankruptcy Code simply to cease operations and liquidate). A Chapter 11 proceeding is a remedy of last resort and requires substantial capital to fund various professional fees, intense adversarial legal contests over interests, priorities, rights, courses of action, and filing and reporting requirements. The time it takes to reorganize a debtor and the low success rate for companies that have attempted to reorganize under chapter 11 are factors that weigh against a chapter 11 strategy. Based on an analysis of the level of distress of the business and its viability with restructured debt, there are some forms of relief that in limited circumstances should be considered as an alternative. This article discusses measures that, if successful, can offer viability to a business in financial distress.

The reference to an “out of court” reorganization or “informal” reorganization refers to a process where creditors consensually agree to a plan of reorganization. It is not binding unless the creditors agree to be bound by it. It bears many similarities to a chapter 11 plan, but in many respects is quite different. In its basic form, the “out of court” reorganization has as its legal basis a composition agreement. A composition with creditors is defined generally as an agreement between an insolvent or embarrassed debtor and two or more of his or her creditors whereby the creditors, for some consideration, such as an immediate payment, agree to the discharge of their respective claims on the receipt of payment that is in a lesser amount than the amount actually owing on the claim.¹ Another definition of a composition agreement is a contract made by an insolvent or financially pressed

debtor with two or more creditors in which the creditors agree to accept some specific partial payment of the total amount of their claims, which is to be divided pro rata among them in full satisfaction of their claims.² In its fundamental form, the essential elements are: an agreement between two or more parties; and a forbearance, compromise, or adjustment of debt. When used in a business setting to address the unsecured creditors, a forbearance and the inducement are key elements of a successful composition agreement.

If indeed a creditor is about to garnish the bank account, the sheriff is going to seize the assets of the company, or the bank is going to exercise remedies such as collection of the accounts receivable, seizure of inventory, or exercise of its rights against the machinery and equipment, a debtor has to look toward a chapter 11 proceeding if it is to have any continued viability. Section 362 of the Bankruptcy Code³ providing for an automatic stay of any action to enforce any rights (subject to exceptions), is a powerful legal tool to obtain relief and have “breathing room” to restructure debt. Section 363 of the Bankruptcy Code⁴ even allows the debtor to use its collection of accounts receivable and cash over the objection of the lender if the debtor can provide “adequate protection” (assurance) that the debtor’s use will not result in the decrease in value of a creditor’s interest in the property. There are numerous other protections offered by the Code even without the creditor’s consent.

If the debtor’s financial distress has not deteriorated to the point of paralysis, and the debtor has the capability of offering its creditors a more attractive alternative than forcing the debtor into bankruptcy, it is an appropriate time to consider and propose a composition agreement.

The composition agreement is similar in some respects but different in others from a chapter 11 proceeding. A chapter 11 proceeding has a disclosure statement and a plan. The offering in the plan is based on a liquidation analysis in which the sums offered to the creditors in the class are greater than what the creditor would realize in a liq-

uidation. Under 11 USC 1126 (d), the plan is accepted by the class if two-thirds of the allowed claims in the class accept. If the plan is confirmed, any dissenters in the class are bound by the plan. Moreover, the court may confirm a plan that “crams down” or binds the creditor to the treatment under the plan even though the class of creditors did not accept the plan. See 11 USC 1129.

In contrast, a composition agreement has a contract as its basis. Under Michigan law, the essential elements of a valid contract are (i) parties competent to contract, (ii) proper subject matter, (iii) legal consideration, (iv) mutuality of agreement, and (v) mutuality of obligation.⁵ The legal question arises whether an agreement to compromise a lawful debt is enforceable since it lacks consideration.

A Michigan statute provides that an agreement in writing and signed by the party against whom it seeks to enforce the change or modification is not invalid because of the absence of consideration.⁶ Since a composition agreement can only bind those who sign the agreement, the requirement that the composition agreement is effective only on the acceptance of a high rate in dollar amount of the creditor class is dictated by the economic reality of the situation. In other words, a substantial portion of the creditor class must be bound, or the composition agreement does not provide the relief or viability needed by the debtor. For example, assume a distressed company owes a total of \$1 million in unsecured account payables that is immediately due and payable. It only has resources to pay \$200,000 of this debt. If only 50 percent of the creditors by dollar amount agree to accept a 20 percent payment in full satisfaction, the company would be in a position where it is paying \$100,000 to the accepting creditors and the company would still owe \$500,000 in immediately due payables. The out of court relief of a composition agreement would not alleviate the company’s distress. Therefore, the company has to require a high degree of acceptance from the creditors by dollar amount as a condition precedent to an effective composition agreement.

A provision of the Michigan Business Corporation Act allows a debtor to take an arrangement or compromise to the state court to sanction and bind the dissenters.⁷ This language generally appears as standard language in articles of incorporation. However, court decisions have severely limited the ap-

plication of this section under the doctrine of preemption.⁸

So the question becomes, why would a creditor agree to sign a composition agreement agreeing to forbear from legal action, compromising its debt, and possibly terming out debt that is due and owing? Simply stated, the inducement comes from the economic reality of the situation. The prime documents to present to the creditors are quite similar to bankruptcy law. These include a full disclosure of the financial condition of the company, including assets and liabilities, income, and projections, as well as a liquidation analysis showing the likely distribution to the creditor if the business is liquidated. If the economic reality is that there is no practical likelihood that the creditor will get repaid if it does not participate, the creditor has an inducement to enter into the composition agreement.

Lastly, the composition agreement has greater flexibility than a Chapter 11 proceeding since it does not have court-mandated oversight and regulatory requirements. The creditors may wish to have independent counsel or a restructuring professional review and investigate the books and records of the company, as well as the facts and circumstances of the debtor’s condition before they make a decision. However, most established businesses in the current economic climate have prior experience with customers filing for bankruptcy protection and have often seen little or no return. The out of court process is more expeditious and economical than a formal bankruptcy. The debtor will save substantial money and resources and be at less risk of losing its position in the market place if it can persuade its creditors to enter into a composition agreement.

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Sample Composition Agreement

ABC Company, a [jurisdiction of incorporation] corporation (sometimes referred to as “Company” or “Debtor”), pursuant to the powers vested in the corporation, proposes this arrangement in the form of a Composition Agreement between ABC Company and the Creditor identified below.

Recitals

A. Debtor is unable to pay its Creditors’ (defined below) claims in full and desires to pay the Creditors in accordance with the terms set forth in this Composition Agreement, in full and final satisfaction of the Creditors’ claims, in exchange for a release by the Creditors of any claims, demand, suits, or actions by the Creditors relating to the Creditors’ claims.

B. Debtor and Creditors believe that it is in their best interests to enter into this Agreement and to satisfy and discharge the Creditor’s claims in accordance with this Agreement.

For valuable consideration, the receipt and adequacy of which are acknowledged, and intending to be legally bound, the parties agree as follows:

I. Definitions

1.1 “Allowed Claim” means the claim of a Creditor less any Disputed Amount, until the Disputed Amount has been resolved.

1.2 “Disputed Amount” means the amount that the Creditor’s Estimate, shown on the Acceptance Form, exceeds the Debtor’s Estimate, until the difference or discrepancy is resolved pursuant to Section V(a)(iii) of this Agreement.

1.3 “Resolved Claims” means any Disputed Claims that have been resolved in accordance with Section V(a)(iii) of this Agreement.

1.4 “Event of Default” means the failure by Debtor to make any payment set forth in this Agreement as required and such payment default is not cured within ten (10) business days after delivery to Debtor of written notice of such breach.

II. Class of Creditors

The class of creditors shall consist of those creditors (“Creditors”) that are unsecured, exclusive of creditors who are entitled to priority treatment under the Bankruptcy Code including utilities, taxes, benefits, and current insurers who have outstanding amounts owed from periods prior to [date] (the “Determination Date”).

III. Terms of Repayment

This class of Creditors shall be repaid a total of fifty percent (50%) of their Allowed Claim in full settlement and satisfaction (“Compromise”) of the Allowed Claim, as follows: twenty five percent (25%) of the Allowed Claim shall be paid on the Effective Date, and twenty five percent (25%) of their Allowed Claim shall be paid in twenty-four (24) equal consecutive monthly installments commencing on the first day of the month following the Effective Date, and then on the first day of each month thereafter. No interest will accrue or be paid relating to the Allowed Claims. For administrative convenience and cost savings purposes, the Debtor may, in its sole discretion, make a greater percentage and quicker distribution on any Allowed Claim totaling less than \$1,000.00.

IV. Effective Date

This Composition Agreement shall be effective, binding, and enforceable according to its terms, on the date that is seven (7) business days after the earlier to occur of : (i) acceptance of the Composition Agreement by Creditors holding at least eighty-five percent (85%) in the aggregate of the amounts outstanding on the Determination Date, or (ii) the sanction of this Composition Agreement by a court of competent jurisdiction, if fifty percent (50%) in number and three quarters (3/4) in value of the creditors enter into the Composition Agreement (the “Effective Date”).

V. Allowed Claim/Disputed Amount

a. For purposes of determining the amount of your Allowed Claim for payment purposes:

(i) By entering into an Acceptance of this Composition Agreement without inserting an amount other than the amount set forth in the Debtor Estimate, you are agreeing that Debtor's Estimate is correct and constitutes the amount of your Allowed Claim.

(ii) If you disagree with Debtor's Estimate and you wish to accept the Composition Agreement and assert a different claim, you should insert into the Acceptance Form the amount which you believe to be the appropriate amount of your Claim against Debtor as of the Determination Date, less any appropriate credits ("*Creditor's Estimate*").

(iii) If you and Debtor are unable to amicably resolve the Disputed Amount, Creditor agrees that its sole and exclusive remedy is the right to have the dispute arbitrated with one (1) arbitrator, in an expedited proceeding in accordance with the rules of the American Arbitration Association. The arbitration will be conducted in Southfield, Michigan, and the decision of the arbitrator shall be final and binding on all parties, with no right of appeal; *provided, however*, the award, including costs, shall be judicially enforceable consistent with this Agreement. Requests for arbitration must be filed within 30 days of the Effective Date of this Agreement. If the Creditor does not make a timely request for arbitration, the Claim of such Creditor shall be allowed in the amount of the Creditor's Estimate.

b. Any Resolved Claim shall be paid in accordance with the distribution percentage set forth in Section III above for the payment of Allowed Claims in twenty-four (24) equal consecutive monthly installments with the first payment to be made at the time of the Debtor's next scheduled payment on the Allowed Claims.

VI. Moratorium

Each Creditor agrees that (i) unless it receives a notification by the Debtor that the requisite acceptances and the sanction of the Composition Agreement by the Court have not been obtained, it will not take any action against the Debtor (or its property) to enforce, collect, or commence or continue any proceedings with respect to its Claim and (ii) after the Effective Date and prior to an Event of Default, it will not take any action against the Debtor (or its property) to enforce, collect, or commence or continue any proceedings with respect to its Claim, and will dismiss any pending actions with respect to such Claims.

VII. Release

In consideration for the Debtor's commitment to make the payments in accordance with this Agreement and other good and valuable consideration, except for the obligations created by this Agreement or acknowledged as continuing in force, each Creditor, for itself, its respective predecessors, successors, parents, subsidiaries, and all other persons or entities claiming by or through it (collectively, the "*Releasers*"), releases, acquits, absolves, and forever discharges Debtor and each of its respective predecessors, successors, parents, agents, employees, representatives, partners, officers, directors, shareholders, attorneys, and insurers (collectively the "*Releasees*") of and from any and all manner of actions, causes of action, in law or in equity, debts, contracts, claims, suits, damages, losses, costs, judgments, or expenses, of any nature whatsoever, known or unknown, fixed or contingent, direct or derivative, subrogated or assigned, suspected or unsuspected, which the Releasers have or may have against any of the Releasees by reason of any matter, cause, act, omission, or thing whatsoever to the date of this Agreement, including without limitation, any and all causes of action, claims, demands, costs, expenses, losses, and damages arising out of or in any way relating to their respective Allowed Claim.

VIII. Enforceability

This Composition Agreement shall be governed and construed according to the laws of the State of Michigan. If Debtor receives an acceptance of fifty percent (50%) in number and three-quarters (3/4) in dollar amount, Debtor reserves the right to file an action in a court of competent jurisdiction in the State of Michigan seeking, pursuant to MCL 450.1204, to obtain an order to sanction the compromise arrangement and bind the dissenting creditors to the terms of the composition Agreement.

IX. Miscellaneous

a. *Entire Agreement.* This Agreement constitutes the entire agreement and the complete and conclusive understanding between the parties with regard to the subject matter of this Agreement. There are no oral or other agreements or understanding affecting this Agreement. This Agreement supersedes and cancels all previous discussions, negotiations, agreements, and commitments, oral and written, relating to the subject matter of this Agreement. This Agreement may not be amended, waived, or discharged except by an instrument in writing signed by the party against whom enforcement is sought.

b. *Notices.* Any notices required or permitted under this Agreement shall be in writing and may be delivered personally, transmitted by facsimile, e-mailed, or mailed by first class mail, to the parties at the addresses and facsimile numbers listed on the Acceptance Form or to such other address or facsimile as any party may designate by notice to the other parties.

c. *Counterparts; etc.* This Agreement may be executed in any number of counterparts with the same effect as if all parties had signed the same documents. Each counterpart shall be deemed to be an original copy of this Agreement and all counterparts shall be construed together and be deemed to constitute a single document. Any party's signature to this Agreement or on the Acceptance Form delivered by facsimile or other electronic transmission shall be deemed to be an original signature page to this Agreement and shall be given the same force and effect as an original signature to this agreement for all purposes.

If you decide to accept this proposal to enter into this Composition Agreement, please fill out, sign, and return the acceptance below.

ABC Company

BY: _____

ITS: _____

DATED: _____

Acceptance Form

The undersigned creditor of Debtor in the amount of \$_____, accepts the terms of the Composition Agreement set forth above.

“CREDITOR”

Creditor’s Name

By:_____

Its:_____

Authorized Signature

Dated:_____

PLEASE FORWARD THIS EXECUTED
COMPOSITION AGREEMENT TO:

SEND DISTRIBUTION TO:

NOTES

1. *Am. Jur. 2d, Composition with Creditors* § 1.
2. *West's Encyclopedia of American Law*, (2d ed.).
3. 11 USC 362.
4. 11 USC 363.
5. See *Thomas v Leja*, 187 Mich App 418 (1991).
6. MCL 566.1.
7. MCL 450.1204, which provides in pertinent part: Sec. 204. The articles of incorporation may contain the following provision or the substance thereof: When a compromise or arrangement or a plan of reorganization of this corporation is proposed between this corporation and its shareholders or any class of them, a court of equity jurisdiction within the state, on application of this corporation or of a creditor or shareholder thereof, or on application of a receiver appointed for the corporation, may order a meeting of the creditors or class of creditors or of the shareholders or class of shareholders or of the shareholders or class of shareholder to be affected by the proposed compromise or arrangement or reorganization, to be summoned in such manner as the court directs. If a majority in number representing $\frac{3}{4}$ in value of the creditors or class of creditors, or of the shareholders or class of shareholders to be affected by the proposed compromise or arrangement or a reorganization, agree to a compromise or arrangement or a reorganization of this corporation as a consequence of the compromise or arrangement, the compromise or arrangement and the reorganization, if sanctioned by the court to which the application has been made, shall be binding on all the creditors or class of creditors, or on all the shareholders or class of shareholder and also on this corporation.
8. Statutory provisions that authorize court-approved reorganization plans binding on corporate creditors conflicted directly with and were preempted by ERISA as allowing corporate employers unilaterally to alter their ERISA plan obligations, subjecting plan contributions to financial conditions of reorganized corporations, and substantially affecting administrative ability of plans to calculate benefit levels, make disbursements, and monitor availability of funds for benefit payments (29 USC 1132(g)). *In re Michigan Carpenters Council Health & Welfare Fund*, 933 F2d 376 (6th Cir 1991), *cert den* (1991) 502 US 982. Language in an order approving a compromise arrangement between a corporation in receivership and its creditors over the objections of one of the creditors is invalid where the practical effect of the language is to discharge the corporation's obligations to the objecting creditor; the trial court has no authority to make such an order because the Federal bankruptcy act has preempted the field (11 USCA 1 et seq.; CL 1948, 450.4[3]). See *Coburn Leasing Co; Jerry Davidson, Inc v Michigan Nat'l Bank*, 54 Mich App 228, 220 NW2d 714 (1974).



Thomas K Lindahl of McDonald Hopkins LLC focuses his practice on corporate and commercial matters including representation as general corporate counsel and advisor, commercial transactions, and business litigation. He also has extensive experience in debtor/creditor relations, insolvency, business workouts, and reorganizations both in court and out of court. In addition, Mr. Lindahl has extensive experience in bankruptcy litigation.