

Expect Scrutiny In Del. Bankruptcy-Alternative Proceedings

By **Robert Velevis, Charles Persons and Michael Fishel** (July 29, 2022)

The Delaware Court of Chancery took the old maxim "justice delayed is justice denied" to heart recently, when it denied a request for a stay of proceedings hours after the request had been filed.

The ruling from Vice Chancellor Paul A. Fioravanti Jr., in *In re: Kidbox.com Inc.*, is the latest in a series of rulings from the Court of Chancery requiring litigants in bankruptcy-alternative proceedings in Delaware to support their petitions for relief with sufficient disclosures, and to avoid bare-boned pleadings.

These rulings further signal that counsel engaged in bankruptcy-alternative proceedings in Delaware should be prepared for a higher level of scrutiny from the Court of Chancery.

Factual Background

The petitioner, Kidbox.com, provides clothing-in-a-box services for kids — similar to services like Rent the Runway, but for a younger audience. Faced with being behind on its payments to certain creditors, Kidbox filed a petition for assignment for the benefit of creditors, or ABC — a statutory form of relief governed by Chapter 73 of Title 10 of the Delaware General Corporation Law.

Under an ABC, a company struggling with solvency enters into a contract with an assignee that then monetizes the company's remaining assets, so that the assets may be distributed to the company's creditors.

ABCs are part of a suite of state-law remedies that are increasingly being used by dissolving companies as alternatives to bankruptcy, because such remedies require less oversight from courts, have fewer statutory requirements and can potentially avoid the reputational consequences of declaring bankruptcy.

Another difference between bankruptcy proceedings and ABC proceedings in Delaware — and one particularly relevant to *In re: Kidbox.com* — is that companies petitioning for ABCs in Delaware are not granted automatic stays of collection efforts, foreclosures and litigation.

So, in addition to asking the court to accept jurisdiction over its ABC, Kidbox's petition also asked the court to issue "a stay of collection and litigation against Kidbox and the Assignee



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comparable to the 'automatic stay' provisions under the Bankruptcy Code."

Kidbox's petition, however, failed to provide any facts or argument in support of a stay. Instead, it merely noted that the Court of Chancery had previously ordered stay provisions comparable to those requested by Kidbox, and remarked that the stay was "intended only as an interim measure to channel the claims adjudication process into [the Chancery] Court."

In a four-sentence order, Vice Chancellor Fioravanti denied Kidbox's request for a stay. Vice Chancellor Fioravanti noted that Kidbox's petition and a related letter to the court did "not provide any information supporting the entry of a stay," and instead "largely copied, nearly verbatim," a petition in a previous Court of Chancery case where a stay was denied after the petition similarly failed to provide any grounds for a stay.

The ruling also cited to an order from a corporate dissolution case that had been issued less than a week earlier. In that case, *In the Matter of Global Safety Labs Inc.*, a dissolved company petitioned the Court of Chancery for determinations regarding its obligations to post security for claims brought against it by creditors.

The court noted that the "brief and conclusory" petition failed to include a number of essential facts that could support a ruling on the petition, including basic facts about Global Safety Labs' business, its organizational and capital structure, and the events that led to its dissolution.

The court ended by noting that, in *ex parte* proceedings such as the bankruptcy-alternative proceedings involved in *In re: Kidbox.com and Global Safety Labs*, "counsel have a heightened obligation to provide information to the court," so that the court has sufficient information on which to base its rulings.

Key Takeaways

Litigants in Delaware seeking to stay collection actions or litigation in an ABC proceeding should be prepared to support their request for a stay with sufficient facts and arguments, and should expect that the court will closely scrutinize their request.

Specifically, in *Kidbox*, the Court of Chancery noted that the petitioning party must demonstrate the following three elements in the petition to obtain a stay: (1) precedent for approving the automatic stay; (2) justification for such relief; and (3) the effect the stay would have on pending litigation. In *Kidbox*, the petitioning party failed to meet this test.

While ABCs may sometimes offer a more efficient approach to liquidate a company than what a traditional bankruptcy proceeding might offer under Chapter 7, or in some instances Chapter 11, recent ABC precedent indicates that formalities and fulsome pleadings for relief should not be ignored by petitioning parties.

Specifically, developing case law in Delaware suggests that courts will require more substantive pleadings in all bankruptcy-alternative proceedings, and counsel should be aware of the "heightened obligation" they have to provide the court with sufficient facts to support a ruling on petitions in these proceedings.

The Delaware Court of Chancery has indicated that conscientious practitioners can glean insight into what is required by considering similar pleadings in bankruptcy court. For example, litigants seeking court determinations on their obligations to post security for

claims would do well to model their petitions on first-day declarations used in the bankruptcy context.

In fact, in one recent ABC, the Chancery Court went as far as suggesting that "the concept of a first-day declaration can serve as a guide." Typically, a well written first-day declaration outlines the factual background of a Chapter 11 debtor's business history, corporate and capital structure, financial affairs, reasons for filing for bankruptcy relief, and the debtor's strategy for exiting bankruptcy, if one exists.

This document will generally provide a helpful road map for the case, and assist the bankruptcy judge in better understanding why she should grant first day relief. This is in line with Vice Chancellor Fioravanti's request that petitions include more detail about "the entity, its history, the path that led to the relief being sought, and the parties who could be affected by the relief."

Even if the Chancery Court were to grant some type of injunctive relief prohibiting — or at least temporarily suspending — litigation, nothing would preclude creditors from filing an involuntary bankruptcy petition against a debtor as an ABC is ongoing. While the debtor can move to dismiss the involuntary filing, the added administrative costs to pursue a dismissal could significantly undermine the cost-efficiency purpose of the ABC.

To that end, petitioners seeking injunctive relief should be mindful of any unintended consequences when seeking such relief.

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