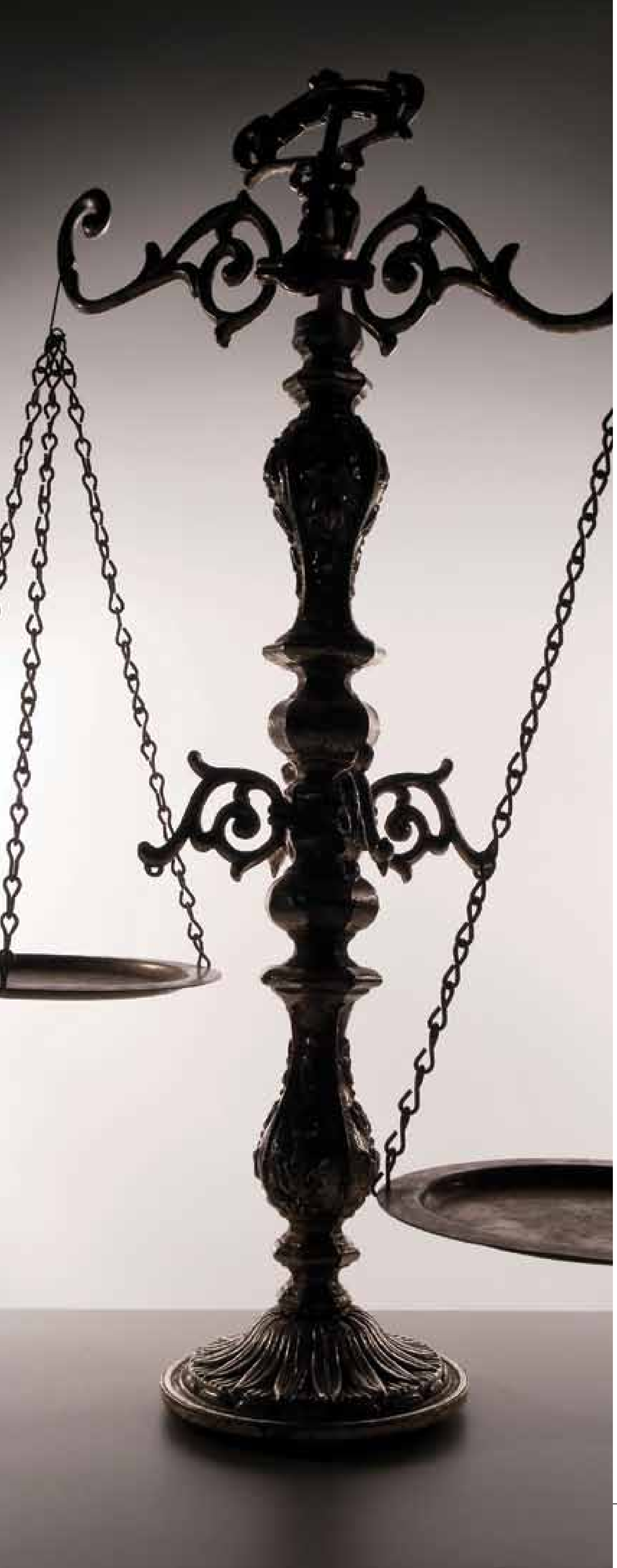

RECEIVERSHIPS

Weighing the Receivership Option

BY ALEX D. MOGLIA, PRESIDENT, & GARY A. WENCEL, MANAGING DIRECTOR, MOGLIA ADVISORS

Under certain circumstances, a receivership may be the best alternative for lenders, trade creditors, or owners who are in conflict with their fellow owners. This article discusses business receiverships, their prerequisites, and their potential benefits and pitfalls.

State courts differ as to who can be a receiver. Some require that a receiver be a natural person, while others allow corporations to serve in the role. Federal courts have also allowed corporations to act as receivers. The qualifications of a receiver may be detailed in various state laws and statutes that enable receiverships. Federal court receiverships, which historically have been rare, are governed by Rule 66 of the Federal Rules of Civil Procedure. Generally, a controversy between residents of different states is required to have a receiver appointed in federal court. For example, a dispute between a borrower in Illinois and a bank headquartered in Pennsylvania could lead to a federal receiver being appointed.

The requirements of a receivership generally dictate the kind of party best-suited to handle the situation. In a business receivership, for example, a strong background in business management, finance, and operations is important, as is the ability to work with legal counsel. Experience in reporting to the court and in communicating with creditors, customers, and employees with respect to the receivership—both written and verbal—is also highly desirable. Bankruptcy trustees fit this description, as do turnaround consultants, both of whom regularly deal with contentious business situations. Attorneys with strong business experience are also good candidates as receivers.

A receiver may need to retain key professionals to assist in the administration of a matter. These usually include legal counsel and tax return preparers, but may also include turnaround professionals, valuation advisors, investment bankers, and others who may be required. As with a receiver, experience in prior receiverships is extremely helpful for these professionals.

Factors to Consider

In weighing a receivership over other alternatives, such as a negotiated settlement or bankruptcy, several factors should be considered.

First, a receiver takes possession of the assets in question, supplanting those previously in control of them. When there is concern over the dissipation or squandering of assets or if fraud or criminal activity is suspected, this is a key benefit of a receivership. Negotiated settlements may drag on or ultimately fail, allowing the undesirable activity to continue. An involuntary bankruptcy filing does not address these issues either, because the debtor remains in control of the business and its assets unless the court takes the unusual step of appointing a Chapter 11 trustee.

Second, a business placed in receivership remains the same with the exception of who controls it and has the added advantage of continuity of recordkeeping. Bankruptcy requires the cut-off of records as of the petition date and separate tracking of pre- and post-petition transactions, which can be burdensome for a company.

Third, the additional administrative burden of bankruptcy, in terms of professional fees, costs, and the notice and objection periods required, may limit the effectiveness of such a filing. Receivers generally have more freedom of action than a trustee does.

Fourth, a receiver's fees are usually negotiated with the creditors who sought his or her appointment and may involve a flat fee for the entire engagement, a flat weekly fee, hourly charges, or success fees (from a sale of assets). A bankruptcy trustee is compensated based on disbursements made from the bankruptcy estate, including any payments made to secured creditors. Fees are calculated on a sliding scale, which approximates 5 percent of disbursements up to $1 million and 3 percent of any payments of more than $1 million. Depending on the level of business activity, a trustee's fees can become sizable relative to receiver's fees.

On occasion, receiverships encounter difficulties arising from the order of appointment. Generally, it is a good practice to authorize a receiver to sell assets or liquidate a business that cannot fund itself. However, this authority is sometimes left out of the order, either intentionally or otherwise. Because many receiverships result in liquidation—indeed, many view "receiver" as a synonym for "liquidator"—omitting this authority from an order of appointment can result in delays and increased legal costs if a receiver must return to court to obtain permission to sell certain assets.

As with most matters, receiverships also are more manageable and tractable with agreement among the parties involved. At minimum, legal costs are lower and the timing of implementation is shorter. In adversarial or highly negotiated situations, the costs can be considerable and the conditions imposed on the receiver may be so onerous that they limit the effectiveness of the receivership.

The experience of the legal professionals involved can also positively or negatively affect a receivership. For creditors, employing counsel who is familiar with the process for seeking appointment of a receiver is critical. Counsel should be experienced in addressing the severity of the situation and explaining to the often overworked state or federal court why a receivership is necessary. For receiver's counsel, familiarity with the process and reporting requirements of the court, the ability to juggle multiple issues on behalf of the receiver, and a solid understanding of the receiver's duties and the related business issues are extremely useful.

Courts do not take the appointment of a receiver lightly. They view imposition of court control through an outside party as an extreme option and one that will require a good deal of the court's time. Accordingly, a motion to appoint a receiver should indicate that other approaches to resolving the underlying controversy have been ineffective or likely would be. Courts may reject or at least delay consideration of receivership motions if such issues are not addressed in the motion.

To avoid many of these potential pitfalls, an order of appointment should be drafted carefully. It is advisable and beneficial for the receiver candidate to be involved in the preparation of the draft order to the extent of laying out the receiver's duties, the reporting schedules, and other case-specific duties.

Avoiding Receivership

For practitioners in the troubled company space, it is also useful to know how to combat

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a receivership. The first method is the simplest—full disclosure and cooperation. Creditors seek receivers when they believe bad acts have occurred or are ongoing. By communicating openly and regularly and by cooperating with creditors, owners and managers of a company can avoid being replaced and facing the related legal and emotional issues—sort of a victory by surrender.

Perhaps less noble, a second option is to be a stickler on strict adherence to the precise language regarding the receiver's duties stipulated in the order of appointment. To the extent that an appointment order is silent on certain issues or limits a receiver's authority, a company can challenge many proposed actions by a receiver, a tactic that can limit the receiver's effectiveness until some other resolution can be obtained. Although this admittedly is simply a delaying tactic, circumstances sometimes may warrant the use of such an option in some cases.

A company also may defeat a receivership by filing bankruptcy. This can be an option if a receiver is intent on liquidating a business, but the company or its owners believe reorganization in bankruptcy has a good chance of succeeding. However, one should consider the low probability of success in Chapter 11 cases (about 10 percent) before recommending this course of action, especially bearing in mind the administrative overhead related to a bankruptcy filing.

Receivers in Action

A company that held itself out as a highly successful, religious-based multimedia communications company sought lease financing from a number of financial organizations to acquire equipment for copying sermons and inspirational speeches for distribution to minority outreach programs. The company's offices in Oak Brook, Illinois, were filled with high-quality furniture, equipment, and numerous personnel—at least when creditors first visited. When the company stopped answering its phones, however, creditors discovered that the equipment and records had been removed from the premises and that the "personnel" had actually been actors hired by the company.

The defrauded creditors considered their options, and decided on a receivership rather than an involuntary bankruptcy because of the flexibility and associated administrative costs of the process. An initial round of funding for the receiver and his legal counsel was raised from the creditors, and the receiver was charged with searching for corporate records, bank accounts, and related documents; investigating the whereabouts of the company's quickly dissipating assets; meeting with former officers, principals, and employees, as well as professionals employed by the company; and analyzing potential causes of action against parties involved in the matter.

Creditors requested the receivership in U.S. District Court because they believed that assets and funds had been moved from Illinois to multiple states, and the order of appointment authorized the receiver to conduct the activities agreed upon. At a pace that would not have been possible in a typical bankruptcy, the receiver's counsel subpoenaed records for the company as well as a number of related entities from multiple banks in several states, froze bank accounts in multiple states within hours, interviewed numerous parties, and traced funds from the company to various recipients.

After initiating litigation, the receiver recovered funds from numerous parties, as well as the personal residence and luxury vehicles owned by the principal owner of the company, resulting in a partial recovery to creditors. The owner of the company eventually was convicted of fraud and sentenced to federal prison.

Another company, a long-established motion picture laboratory and storage facility, had locations across the country. When business operations deteriorated, the company's lender became concerned about the security of its collateral and the erratic behavior of the owner of the business.

The bank sought appointment of a receiver to safeguard the company's assets and committed to funding operations should the receiver determine that to be appropriate. The receivership was requested in federal court because of the company's multistate footprint and the controversy among citizens of multiple states.

The receiver and his team quickly assessed the situation and determined that operations should be restarted. Former employees of the business were contacted and quickly brought back to work. Anxious customers were reassured and access to stored films was re-established, accounts receivable were collected, and customary billings continued.

With the bank's cooperation, the business was successfully restarted and remains in operation, although with a different structure. In an attempt to regain control of his company from the receiver, the owner filed a voluntary Chapter 11 bankruptcy petition and the receivership was dismissed. However, the company continued to operate under court scrutiny, albeit under the bankruptcy court rather than district court.

In another situation, a lender discovered that two different borrowers—one that purported to have offices in Georgia and the other in Ohio—had obtained loans from two separate banks against the same collateral. The circumstances came to light when the banks merged and the problem loans were consolidated into one department. Based on its internal investigations, the lender alleged that fraud had been perpetrated and sought appointment of a receiver to secure and maintain the companies' assets. The receivership motion was brought *ex parte* (without notice to the defendant) to prevent the perpetrators from running off with company assets.

The receiver was appointed on day one and on day two traveled to the purported locations of the two borrower businesses, only to find that both businesses had either moved or been shut down without notice to the lender. Further investigation by the receiver revealed that one or both of the companies had been sold to another unrelated party. The receiver tracked down the owner of the two businesses and confronted him at the offices of his family's business. He admitted to the deception and on day three tendered a written settlement offer to the petitioning bank. The owner subsequently pled guilty to fraud charges and is awaiting sentencing for a scheme involving 17 different lenders and more than $52 million in loans.

Receiverships can also be used to preserve and maintain businesses that are experiencing conflicts or disputes among the owners and operators. In one case, two brothers claimed ownership interests in related businesses. Further, one of the brothers claimed breach of contract and fiduciary duty against the other. He asserted that assets of the jointly owned entities were being improperly removed for the benefit of only the other brother.

A receiver was sought to maintain and manage the businesses while the issues were investigated and litigated. A receiver was appointed by the state court and immediately took control of the bank accounts and cash balances of the businesses. Payables were reviewed and requests for disbursements, including payroll, were evaluated and authorized by the receiver. Regular procedures were put in place with regard to bank reconciliations and payments to lenders and unsecured creditors.

Inspections of each business also were conducted and employees were informed of the receiver's status and authority to manage the businesses. Ultimately the businesses and related land trusts were dissolved by the court and the proceeds of the dissolution were divided by the brothers.

In another case, a lender was concerned over the business prospects, collateral reporting, and business practices of one of its borrowers, a small chain of eyeglass/eyewear retail stores. The lender sought appointment of a receiver to prevent the dissipation of corporate assets or the destruction of the corporate businesses.

The receiver immediately assessed the operating stores and determined that without additional cash support the stores were not viable businesses. Accordingly, the receiver shut down the businesses to preserve assets that remained and arranged for the sale of certain of the businesses to unrelated parties, pursuant to orders of the court. Proceeds of the sale were paid to the secured lender.

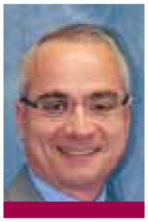
In yet another case, the lenders to a subprime auto insurance finance company believed fraud or malfeasance had occurred with respect to securitized notes issued by the borrower. As premiums were collected, the proceeds were to be paid to the note holders. However, such was not the case.

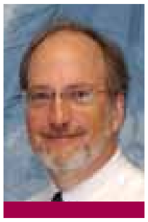
The lenders sought appointment of a receiver for the borrower's bank accounts, rather than for the business itself. The lender believed that, because all collections were to flow through the borrower's accounts, such an appointment would give effective control of the business to the receiver.

However, numerous operational difficulties arose under this arrangement, resulting in requests by the receiver for expansion of his authority amid intense discussions with both the lenders and the borrower. Ultimately, that authority was granted, and the business was sold to another player in the vehicle premium finance industry. The former owner and CFO subsequently were convicted of wire fraud and were sentenced to prison.

Preserving Value

A court-appointed receivership can be a timely and cost-effective method for preserving business and asset values and for investigating allegations of fraud and recovering assets. Experienced professionals can act quickly to clarify contentious situations for lenders, creditors, and borrowers. CR





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