RECEIVERSHIPS

Substance Over Form: Equity Receivers in SEC Enforcement Actions

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When the U.S. Securities and Exchange Commission (SEC) was formed in 1934, it undertook a six-year study to "investigate the work, activities, personnel, and functions of protective and reorganization committees,"[1] to wit, receiverships and trustees in equity and bankruptcy reorganizations.

The committee, headed by William O. Douglas and later by Abe Fortas when Douglas ascended to the U.S. Supreme Court, concluded that the trustees and receivers of the day were often "too friendly" with the companies they were charged with running and reorganizing. Management, possibly corrupt, often remained in place during the reorganization or winding-down activities. The result, from the SEC's perspective, was that "the security holders—the real owners of the failing businesses"—got the short end of the stick in such cases.[2]

Based on the study, the SEC began a push for qualified and independent receivers to take control of companies suspected of securities violations when investor funds were in jeopardy. But it would be many years—indeed, not until the 1980s—before the SEC began to rely with any consistency on equity receivers when faced with the dilemma of what to do with a company that had served as the means for a fraud but, at the same time, might still need to operate to maximize investors' recovery.

Why the SEC Seeks a Receiver

When the SEC believes that investor funds are in jeopardy, it typically seeks a temporary restraining order to halt misconduct and a freeze order to secure any assets subject to the alleged fraud. Once a company's assets are frozen, the SEC frequently asks the court to appoint a receiver to evaluate whether the business should continue to operate or be liquidated. The receiver is empowered to hunt for and recover other assets of the estate.

The SEC has many of the same equitable powers as a receiver to trace and seize assets. The agency can pursue so-called "relief defendants"—persons or entities that, while not having engaged in any wrongdoing, received ill-gotten assets as a result of illegal acts of the defendants. For example, if Ponzi schemer Bernie Madoff bought a Ferrari for a relative, that relative, although he may be unaware that the gift was procured with proceeds of a fraud, could be sued as a relief defendant to recover fraudulently transferred assets and return their value to the fraud victims. Under the same theory, the SEC could bring litigation throughout the country to recover assets from those who were unjustly enriched as a result of the securities fraud.

That said, a receiver nevertheless has some advantages over the SEC in conducting litigation, which may lead the agency to request that a receivership be formed. Because a receiver stands in the shoes of the defendant, he or she can bring certain claims on behalf of the defendant that would fall outside of the SEC's jurisdiction, such as a breach of contract claim against a vendor. And even if a receiver only brought claims that the SEC could theoretically prosecute, a receiver avoids the red tape that would slow or possibly prevent similar actions by the SEC. Put simply, a receiver doesn't need to get approval from regional supervisors or the commission every time he or she wants to file a claim against a new party.

In addition to the receiver's potential litigation edge, other basic reasons the SEC might want a receiver appointed include: (a) to avoid exacerbating harm to investors by an immediate shutdown of a company or to mitigate further harm by a careful continuation of the company's operations; (b) to handle complicated matters concerning the tracing, recovery, allocation, and distribution of assets among a diverse and large group of investors and account holders that would otherwise waste or tie up significant government resources; and (c) assets may need to be liquidated in the open market.

As a practical matter, the SEC is not set up to manage companies efficiently and does not have the necessary expertise to operate a company. A receiver can more easily employ professionals who have the required expertise to liquidate assets, including securities and commodity positions, and undertake the complicated accounting work needed to enable the allocation and distribution of the remaining cash and securities.

Often the sheer number of investors involved creates a need for a receiver to handle the flood of investor calls, evaluate claims, and return proceeds, all of which can be incredibly time-consuming and costly. And given that one of the main purposes of a receivership is to return money to investors and other creditors, it is reasonable for the costs of the receivership to be borne by those who benefit from it and not by taxpayers at large. Because he or she is paid from the estate, a receiver's appointment shifts the cost from the taxpayer to the estate.

Put differently, the SEC's job is one of enforcement and regulation, not running down assets on behalf of investors who may have been aggrieved. So, when it is either necessary to displace management of a defendant-company or when faced with a massive fraud involving numerous victims, the SEC often recommends one or more individuals to a judge as possible candidates to be appointed as a receiver.

A Receiver's Power

While courts are not bound by an SEC recommendation to appoint a receiver, judges usually agree. Receivers in current SEC-related cases are usually attorneys who possess expertise in investor issues and have backgrounds in securities or who worked for the SEC or other governmental agencies. Unlike their counterparts of the 1930s, they are not beholden to the industry or companies in whose shoes they stand. Indeed, a receiver is not even accountable to the SEC. In this way, the agency has avoided the failings of the receiverships from the early 1900s.

Rather, as an officer of the court, a receiver is directly accountable to the judge who appointed him or her. *McClain v. Saranac Mach. Co.*, 94 Colo. 145, 28 P.2d 1009 (1934).[3] Hence, when a receiver is not litigating on behalf of the receivership estate, he or she is a de facto agent of the court. Viewed by the judge as a neutral party whose overarching goal is to maximize the receivership estate for the benefit of the investors, a receiver serves as the court's eyes and ears, and the judge is likely to give great weight to his or her recommendations in reaching decisions.

While the powers of an SEC receiver stem from Federal Rule of Civil Procedure 66 (concerning the appointment of receivers), the federal courts have broad equitable powers to protect investor funds and to prevent wrongdoers from profiting from their misconduct. A receiver acts under the umbrella of the court's equitable powers and is subject to its orders. As such, a receiver has extraordinary latitude to handle creditor claims, settle corporate debts, and, if necessary, institute judicial proceedings in a pragmatic manner that elevates substance well above form to speed the recovery process for investors.

Specifically, SEC receivers can bring cases in the receivership court without being required to establish an independent basis for federal jurisdiction. Receivers can and often do seek stays or bars of other litigation that

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might impact the receivership estate. They can also institute summary proceedings to determine whether an asset is part of an estate or creditors' claims can be rejected in whole or part, or to handle objections to a proposed plan of distribution.

A summary proceeding satisfies due process requirements if the claimant is noticed and has an opportunity to be heard. This enables both the receiver and the court to move a receivership along at a quicker pace than would be likely in an ordinary legal proceeding and, consequently, to return assets to investors long before underlying regulatory and criminal litigation is resolved and to do so with less expense.

The order of appointment, which defines the scope of a receiver's powers, charges the receiver with marshaling and securing the assets of the company for the benefit of investors and creditors. If the scheme includes income-producing assets, then the receiver can manage those assets pending their sale. The receivership may take control of real or personal property, which the receiver will sell to maximize the estate.

Because of the receiver's equitable powers and the broad discretion given to the court, a receiver is in a strong position to obtain a better result than would otherwise be achievable when settling and cancelling obligations taken on by the corporation. For example, costly commercial office leases may be well in arrears and may have long terms and significant penalties for cancellation. While commercial landlords or lenders might have a strong position for a claim in a bankruptcy proceeding, they are on thin ice in an equity receivership and thus are more likely to enter into a resolution more favorable to the receivership estate.

While it is common to equate an SEC receiver to a bankruptcy trustee, there are significant differences. Unlike a bankruptcy trustee, whose powers are governed by statute and a large body of case law, the powers of an equity receiver derive from the court order appointing him or her. Thus, a receiver is fundamentally bound only by the judge's sense of equity and fairness. Decisions by the district court approving actions by a receiver can only be overturned for abuse of discretion.

For example, with respect to distributing assets to investors, two very different methods of allocation were employed in two recent receiverships in the 7th Circuit involving the same receiver and the same judge, *Phillip Stern Receiver for Scott M. Ross*, No. 08 CV 1260, United States District Court, Northern District of Illinois, and *Phillip Stern Receiver for Enterprise Trust Company*, No. 08 CV 1260, United States District Court, Northern District of Illinois. The differences arose from the receiver's and the court's sense of what was fair to the particular classes of investors in each case and not from the hard application of legal rules.

Typically, a court favors a pro rata distribution to investors, but it may choose a different method of allocation if warranted. A pro rata distribution was employed in *Ross*, even though there were several distinct groups of investors: those who thought they were investing in a start-up company, those who thought they were purchasing a securities product com-

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prised of life settlement policies, and those who invested in a fund to conduct foreign currency transactions.

In *Enterprise*, however, the court approved a non-pro rata approach in which different classes of investors received different percentage returns, depending on whether they had given discretion to Enterprise to trade their accounts. Two objectors appealed the *Enterprise* allocation and the 7th Circuit, in an expedited appeal, affirmed the plan of allocation, noting that "[d]istrict judges possess discretion to classify claims sensibly in receivership proceedings," that the receiver had a reasonable basis for his recommendation, and therefore that the "district court did not abuse [its] discretion when approving the receiver's proposal."[4]

Notably, in both of those receiverships, virtually all non-investor creditor claims were extinguished without payment to those creditors. Simply put, the receiver decided—and when it was necessary to involve the court, the court agreed with the receiver—that the investors should take priority. And given that the investors effectively paid for the costs of tracing the assets, determining allocations, and handling the proceedings needed to distribute the estate, it was appropriate to limit those recoveries to the investors.

New Era

Receivers have come a long way since the 1930s. Their focus is now on the investors and shareholders who voices are frequently not heard in bankruptcy proceedings and who, if left to prosecute the claims themselves, would likely not be able to afford the work that can be done efficiently and effectively by a receiver. CR

[1] *SEC v. Enterprise Trust Co.*, September 30, 1940 Letter of Transmittal to The President of the Senate, by Jerome N. Frank, Chairman of the Securities and Exchange Commission.

[2] Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part I, May 10, 1937, U.S.G. Printing Office, at 312-316, 897-916

[3] In deciding whether to appoint a receiver, the court weighs the purported harm to the investors in not appointing a receiver against the harm to the defendant-management that is being pushed aside. Receivers are generally appointed on the SEC's application when the court finds that there is a high probability that the SEC will ultimately prove the underlying alleged fraudulent conduct charged in the related SEC complaint, and when there is a significant danger that property will be lost, concealed, squandered, or stolen.

[4] *Securities and Exchange Commission v. Enterprise Trust Company et. al.*, Nos. 08-3798 and 08-3852, (7th Cir. March 18, 2009)

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