Federal and State Court Receiverships as
Alternatives to Bankruptcy – Pros and Cons

I. OVERVIEW

When a company gets into trouble, the immediate reaction of many creditors and lenders is to think about the bankruptcy option. A creditor of, or investor in, a troubled company should consider all avenues available to it, including a possible receivership under applicable federal or state law. Given the right set of circumstances, a receivership may be a better alternative than a filing under the United States Bankruptcy Code, 11 U.S.C. § 101, *et seq.* (the "Bankruptcy Code").

In summary, a state or federal court receivership is an alternative to be considered, along with the benefits and drawbacks of such proceedings in comparison to a bankruptcy case. Most notably, there is not a well-developed body of receivership law, while there is a well-developed body of bankruptcy law. While at first blush a party in interest may conclude that it would rather have the predictability of statutory and case law related to the Bankruptcy Code, the flexibility offered by the less well-established receivership law and statutes may better serve the party's goals, while providing the ability unavailable under the Bankruptcy Code to narrowly tailor relief to particular assets and/or businesses. Further, the petitioning plaintiff in a receivership proceeding can propose as receiver a person or entity it believes is best suited to manage the receivership assets, instead of relying on a standing panel of bankruptcy trustees. The petitioning plaintiff can also carefully draft the order appointing the receiver to provide the receiver broad powers and discretion to manage the receivership assets and estate without requiring regular motion practice before the court.

One significant consideration, depending on which federal or state court the action would be brought, is the ability or inability of a receiver to sell assets free and clear of liens, claims and encumbrances.

Also weighing against seeking appointment of a receiver and in favor of a bankruptcy proceeding, is the need in most cases to establish cause for displacing existing management. No such requirement exists under the Bankruptcy Code when a case is commenced and remains a chapter 7 proceeding. On the other hand, weighing in favor of a receivership is the reduced likelihood that a creditor will be subject to liability for unsuccessfully seeking appointment of a receiver than for filing an involuntary petition under the Bankruptcy Code that is later dismissed.

An interested party should consider the pros and cons of commencing a bankruptcy proceeding and, alternatively, seeking appointment of a receiver for all or some of the defendant debtor's assets and business operations, before blindly proceeding under the more well-known Bankruptcy Code.

II. IDENTIFYING AND APPOINTING THE RECEIVER

A. Types of Receiverships.

There are two basic types of receivers: a general (or liquidating) receiver, and a special receiver. The general receiver is analogous to a bankruptcy trustee in that the receiver controls all the assets and operates the businesses with the intent to either sell such assets as a going concern or liquidate the assets of the business. In either case, the receiver disburses the proceeds to the creditors according to the priority of their interests.

In a special or limited receivership, the receiver only takes possession of designated assets and/or businesses of the defendant debtor and operates and/or sells only those assets or businesses leaving the rest of the defendant's assets and businesses in the possession of the defendant. A limited receiver has no authority over components of the defendant's businesses not subject to the receivership.

B. Appointment of a Receiver.

A receiver may be appointed under either federal or state statutes, which operate in a similar manner. Federal receiverships are especially useful if the receivership assets are located in more than one jurisdiction, as a federal court order can cross state boundaries to provide the receiver control of assets in more than one state. *Livingstone v. Adler,* No. 03-11934-DPW, No. 03-11935-DPW, 2004 WL 438927 (D. Mass. Mar. 10, 2004).

1. Bases for Federal and State Court Jurisdiction and Appointment of Receiver.

a. Federal Court Ancillary Jurisdiction.

Appointment of a receiver is ancillary relief requiring a pending federal court action asserting other substantive claims (i.e. a collection action commenced by a lender). In order to initiate an action in federal court, the federal court must have jurisdiction. Because creditors' rights claims are not typically based upon a federal question, diversity of citizenship and the minimum amount in controversy under 28 U.S.C. §1332 must exist in order to invoke federal court jurisdiction. *See Inland Empire Insurance Company v. Freed*, 239 F.2d 289, 290 (10th Cir. 1956). Once federal court jurisdiction over the substantive dispute is established, the federal court has ancillary jurisdiction to appoint a receiver and ancillary subject matter jurisdiction over actions commenced by the receiver in the carrying out of the receiver's duties. *Haile v. Henderson National Bank*, 657 F.2d 816, 822 (6th Cir. 1981). The minimum contacts analysis of *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), is inapplicable to ancillary actions and proceedings brought by a federal receiver to execute his duties in districts other than the district in which he was appointed. 28 U.S.C. § 1692. Section 1692 allows nationwide service of process in a federal receivership proceeding, and the territorial jurisdiction of the appointing court extends to any judicial district in which receivership property is found.

At least one case suggests that the jurisdiction of the federal court appointing the receiver has some limitations. The Court of Appeals for the First Circuit, in *American Freedom Train Foundation v. Spurney*, 747 F.2d 1069 (1st Cir. 1984), limited the court's ancillary jurisdiction to districts in which real and personal property and those asserting rights in such property are located.

b. State Court Statutory Authority.

A majority of states have enacted statutes authorizing the appointment of a receiver under various circumstances. These circumstances may include waste or material injury to property of the debtor, insolvency, fraud or mismanagement of corporate assets. *See, e.g.*, Del. Code Ann. title 8 § 291 (appointment of receiver for insolvent corporation); N.J. Stat. Ann. 14A:14-2 (same); N.Y. Bus. Corp. Law §§ 1201, *et seq.* and N.Y. Not-for-Profit Corp. Law §§1201, *et seq.* (authorizing appointment of receiver for corporate assets upon, *inter alia*, commencement of dissolution proceeding, proceeding by judgment creditor for sequestration, action by shareholder or member to preserve assets of corporation in absence of in-state corporate officer, or action to preserve in-state assets of out-of-state dissolved or terminated corporation); Md. Corps. & Ass'ns. Code, § 3-418 (authorizing appointment of receiver upon corporate dissolution); Ohio Rev. Code. Ann. § 2735.01 (receivership authorized in pending action where corporation is insolvent or in imminent danger of becoming insolvent) and *Ohio Broadcasting Corp. v. Williamson*, 1933 WL 2217 (Ohio Ct. App Aug. 25, 1933) (necessity is required for appointment of receiver, in addition to insolvency of corporation); 39 Pa. Cons. Stat. § 1, *et seq.* (permitting appointment of receiver for insolvent corporation upon showing of cause as specifically set forth in such statute) and 15 Pa. Cons.Stat. § 1767 (permitting appointment of receiver when corporation is deadlocked). See also Revised Model Business Corporations Act, § 14.32(a) (authorizing appointment of receiver in judicial proceeding to dissolve corporation).

Many states also provide for appointment of a receiver on general equitable principles, whether the debtor is solvent or insolvent. *See, e.g.*, Pa. R. Civ. P. 1533 and *Tate v. Philadelphia Transportation Co.*, 410 Pa. 490, 499-500, 190 A.2d 316, 321 (1963) (receiver may be appointed upon showing of right to such appointment, irreparable damage will in all probability result absent appointment, appointment will not substantially injure or interfere with rights of others, and greater damage will occur absent appointment; Receiver may be appointed if gross mismanagement, fraud or similar circumstances); *Grant v. Allied Developers, Inc.*, 44 Md. App. 560, 565, 409 A.2d 1123 (Md. Ct. Spec. App. 1980) (court may appoint receiver on equitable grounds to preserve solvent corporation's assets where actions of directors, officers, or others are ultra vires, fraudulent, or otherwise illegal).

c. Bases for Appointment of a Receiver.

In a state court action, whether appointment of a receiver is warranted will be determined by applicable state law. In a federal court proceeding, the determination whether to appoint a receiver will be made under federal law. *Waag v. Hamm*, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998). Appointment of a receiver is an extraordinary remedy and is granted only in cases of clear necessity to protect a plaintiff's interest in

property. *Commodity Futures Trading Commission v. Comvest Trading Corp.*, 481 F. Supp. 438, 440, 441 (D. Mass. 1979).

Some states will enforce contractual agreements, including provisions in loan and mortgage agreements, providing for appointment of a receiver under certain circumstances. *See, e.g.*, *Metropolitan Life Insurance Co. v. Liberty Center Venture*, 437 Pa. Super. 544, 650 A.2d 887 (Super. Ct. 1994) (court will enforce contractual provision in mortgage granting lender right to appointment of receiver upon borrower's default); *Philadelphia Trust Co. v. Northumberland County Traction Co.*, 258 Pa. 152, 167, 101 A.2d 970, 974 (1917) (parties have right to provide contractual remedies within their agreements). Further, courts have appointed a receiver when current management or ownership is hopelessly deadlocked, has demonstrated a lack of trustworthiness, or has acted in a manner not in the best interests of the business. *Witters v. Hicks,* 338 Ill. App. 3d 751, 273 Ill. Dec. 863 (Ill. App. Ct. 2003); *ARC Manufacturing Co. v. Konrad,* 321 Pa. Super. 72, 467 A.2d 1133 (Super. Ct. 1983). In addition, courts will commonly consider various additional factors in determining whether to appoint a receiver including:

- the existence of a valid claim of the moving party;
- fraudulent conduct on the part of the defendant;
- imminent danger that property would be lost, concealed, injured, diminished in value, or squandered;
- inadequacy of available legal remedies;
- the probability that the harm to the plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment;
- plaintiff's probable success in the action; and
- the possibility of irreparable injury to plaintiff's interest in the property.

See, e.g., *Waag*, 10 F. Supp. 2d at 1193; *Hamzavi v. Bowen*, 126 Md. App. 492, 497, 730, A.2d 274 (Md. Ct. Spec. App. 1999); *Tate*, 410 Pa 1090, 190 A.2d 316; *Roach v. Margulies*, 42 N.J. Super. 243, 126 A.2d 45 (Super. Ct. App. Div. 1956).

2. Identifying the Receiver.

There are not standing receiver panels, like there are standing Chapter 7 trustee panels in many districts. Therefore, the plaintiff seeking appointment of a receiver has broad discretion in choosing who to propose as the receiver. Selection of an independent, qualified receiver candidate is important in light of the independent duty of the receiver to the court. To the extent specialized knowledge of the business or assets is required or advisable, it is preferable to propose a candidate that possesses such specialized knowledge and/or experience. Such experience, along with a history of prior appointments by courts to serve as a receiver or trustee, will make a candidate more inviting to the court and increase the likelihood that the court will approve and appoint

the candidate as the receiver. Ultimately, however, the receiver's duties run to the court and the court will choose who will serve as receiver.

III. THE RECEIVER'S RIGHTS, POWERS AND RESPONSIBILITIES.

The receiver's rights, powers, and responsibilities are generally set forth in the order establishing the receivership. Therefore, as a general matter, the order appointing the receiver should describe the receiver's rights and duties as broadly as possible, but also be specific enough to avoid later disputes.

A receiver, whether in a state or federal case, is an officer of the court that appoints it and the receiver's fiduciary duties run to the court, not to any particular creditor, not to the defendant debtor, and not to any other party in interest. *Waag*, 10 F. Supp. 2d at 1193. As a matter of law, the appointment of a receiver puts all the property subject to the receivership in the custody of the court. *See* R. Clark, *Clark on Receivers* § 36 (1959) (receiver is an arm or administering hand of the court); *Atlantic Trust Co. v. Chapman,* 208 U.S. 360, 372 (1908) (receiver is officer of court, and its property is *in custodia legis*); *Brunswick Corp. v. J & P, Inc.*, 424 F.2d 100, 103 (10th Cir. 1970) (funds *in custodia legis* are the same as if actual possession is with an officer of the court). Any interference with the receiver's functions is punishable by contempt. *See, e.g.*, *Clear Creek Power & Development Co. v. Cutler*, 79 Colo. 355, 245 P. 939 (1926).

A. <u>The Receiver Order.</u>

Most receiver orders provide that the receiver is (a) to take possession of and preserve certain assets, and/or (b) to take control of and operate certain businesses and/or entities. Because it is the receiver order that sets forth the property subject to the receivership and the respective rights and obligations of the receiver, the defendant debtor, and third parties, great care should be taken in drafting the proposed order to insure that the receiver has sufficient power, authority, and direction to carry out its duties. For example, if the receiver may need to (a) contract with third parties for provision of goods and services for the benefit of the receivership estate, (b) use the defendant debtor's liquor, gambling, or other licenses or apply for new licenses, and/or (c) sue third parties to obtain possession of receivership property, enforce contracts, collect accounts receivable, or evict persons or entities from receivership property, the proposed form of order appointing the receiver should expressly grant the receiver the authority to so act. The order appointing the receiver should also make clear what rights and powers, if any, are retained by the defendant debtor and its officers, directors and shareholders. It is important to note that appointment of a receiver does <u>not</u> prevent a defendant debtor from filing a voluntary petition for relief under the Bankruptcy Code. *See, e.g.*, In re *Cash Currency Exchange, Inc.*, 762 F.2d 542, 552-53 (7th Cir. 1985). However, upon commencement of a bankruptcy case, the bankruptcy court may, pursuant to 11 U.S.C. § 543(d), excuse the receiver from the turnover requirements of the Bankruptcy Code.

The receiver order should also set forth any obligations imposed on the receiver to file inventories, status reports, and other reports with the court regarding the receivership, its assets, its businesses, and its operations. In addition, it is advisable that the order

appointing the receiver set forth the amount or method for calculating the receiver's compensation for service as receiver so that disputes in this regard are avoided.

Once the order appointing the receiver is entered and any conditions precedent to the effectiveness of the appointment satisfied (i.e. posting bonds and/or taking oaths in certain states), the problems and inevitable disputes that led to the request for appointment of a receiver hopefully will cease to interfere with preservation of receivership assets and business operations. Further, the pending court proceeding becomes a relatively efficient forum for resolving disputes between and among the plaintiff, defendant, receiver, and third parties.

B. Notice to Creditors of Appointment.

Various statutes require the receiver to notify creditors and interested parties of the receivers appointment within 30 days of entry of the receivership order. *See, e.g.,* 26 U.S.C. § 6036. Additionally, it is advisable that the receiver record a copy of the receivership order with the county auditor or registrar of deeds if real property is involved.

In connection with a federal court action, 28 U.S.C. § 754 provides that a receiver must, within ten days after entry of the order appointing it, file copies of the complaint and the order appointing the receiver in each district in which receivership property is located. The statute further provides that failure to file such copies in any district divests the receiver of jurisdiction and control over property in that district. 28 U.S.C. § 754. The Third Circuit Court of Appeals considering section 754, however, has held that failure of a receiver to timely file the required documents does not divest the court of jurisdiction once the documents are properly filed. *See S.E.C. v. Equity Service Corp.*, 632 F.2d 1092, 1095 (3d Cir. 1980); *but see S.E.C. v. Vision Communications, Inc.*, 74 F.3d 287 (D.C. Cir. 1996) (receiver's failure to file complaint and order of appointment before commencing action to enjoin interference with sale was fatal, and late filing would not revive court's jurisdiction).

C. Notice of Miscellaneous Matters.

Generally, local rules will require the receiver to provide creditors notice by mail and publication of the need to file claims against the receivership estate. Just like in a bankruptcy proceeding, a creditor may request special notice and, upon such request, the receiver is obligated to include the creditor on all future mailings, unless excused by the court. Creditors and interest holders are entitled to intervene and be heard with regard to services of the receiver, sale of assets, proposed distributions, and similar matters. After all, the receiver is appointed to protect the interests of all parties in interest, not just the interests of parties to the lawsuit.

D. Receiver's Reports.

The most effective way for a receiver to keep the court and the estate informed, and to obtain court orders approving the receiver's actions, is to file regular reports with the court and ask that those reports be made orders of the court.

The receiver's reports serve at least three functions. First, the reports keeps the court and others informed of what has transpired with regard to the receivership estate.

This saves time as the receiver does not have to communicate separately with each creditor and other parties in interest. Second, the receiver's reports, if approved, protect the actions of the receiver from later attack. By filing interim reports and receiving court approval of the actions undertaken, the receiver need not await approval of the receiver's final report, which is filed at the end of the receivership. Third, the receiver's reports can disclose actions the receiver is considering taking in the near future, thereby flushing out objections from the court, the parties, or from other parties in interest, at an early point in time, before the receiver has too much time or too many resources invested in the proposed course of action.

As a general rule, the receiver's reports should be ministerial and non-adversarial. If the receiver desires to undertake actions to which a party or claimant is likely to object, it is probably best to seek approval for such action in a separate motion and not by approval of a receivership report.

IV. ADMINISTRATION OF THE RECEIVERSHIP ESTATE

A. No Automatic Stay in Receivership Proceeding.

Unlike in a case under the Bankruptcy Code, there is no automatic stay preventing the prosecution of suits against a company in receivership. In a federal case, however, federal courts have authority to impose broad stays of all actions against the entities in receivership. *S.E.C. v. Wencke*, 622 F.2d 1363, 1369-70 (9th Cir. 1980).

Nevertheless, the court's possession of the debtor's assets in a receivership proceeding confers upon that court the authority to determine all matters related to the receivership property. Therefore, any attempt to disturb the court's authority over receivership assets may constitute contempt of court.

In addition, there are at least a couple of orders that can be obtained early in the receivership that may provide similar protections to those provided by the automatic stay of 11 U.S.C. § 362:

> 1. Equitable Stay. Allowing an action to proceed that may result in entry of an order against the receiver by another judge in another case can create conflicts for the receiver. For example, if a receiver has control of assets and has been directed to hold such assets for the benefit of all of the defendant debtor's creditors, an order entered by another court requiring the receiver to turnover receivership property to a specific creditor will create an irreconcilable conflict for the receiver. In order to prevent a receiver from being subject to directly conflicting orders issued by different courts, the receivership court can enter an order prohibiting third parties over which it has jurisdiction from continuing litigation in other jurisdictions that seeks to (a) compel the receiver to take or avoid taking certain actions, (b) execute on a money judgment previously obtained, and/or (c) compel discovery, and/or seeking similar relief.
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> 2. Order to Present and File Claims/Bar Date. A bar date is more important in receiverships than in a bankruptcy case. Under *Riehle v. Margolies*, 279 U.S. 218 (1929), a judgment obtained against a company in receivership after the

appointment of a receiver (remember, there is no automatic stay) is binding on the receiver if filed as a claim. Therefore, the receiver may have to fight a suit commenced before or subsequent to the receiver's appointment. The receiver may seek to circumvent the need to defend judicial and quasi judicial proceedings by having an order entered requiring creditors and interest holders to present and file claims in a relatively brief period. The order may set a short bar date for parties and require a filing party to dismiss any other claims (such as pending litigation) before filing its claim in the receivership proceeding. This type of order does not require dismissal of a pending suit *per se*. However, unless trial is imminent, the potential claimant will realize that by continuing prosecution of its claims in the foreign court, it will miss the bar date established by the receiver court. The result commonly is that the creditor dismissed the pending foreign action and files its proof of claim with the receivership court.

B. Budgets and Funding Receivership Expenses.

The order appointing the receiver may provide that proposed budgets be approved by the petitioning plaintiff or by the court on motion. Just like a receiver's authority to operate a business, employ professionals and enter into contracts, a receiver in some states may borrow funds from secured creditors or outside lenders subject to court approval. The court may also provide for the receiver's borrowing of funds from the petitioning plaintiff in the receiver's business judgment and subject to the petitioning plaintiff's consent. Authority, terms and conditions to such borrowing may be set forth in the initial order appointing the receiver or in a subsequent order of the court. Great care should be exercised in determining whether the borrowing will provide a benefit to the receivership estate.

C. Paying Expenses.

Unlike in a bankruptcy case, in a receivership proceeding, the receiver's fees and expenses are generally paid before any other claims, including secured debt. Additionally, any contract entered into by the receiver on behalf of the estate requires court approval. Approval can be obtained in advance by general provisions in the order appointing the receiver, by court approval of an interim receiver's report, or by separate motion. Once approved, the receiver need not get approval for each subsequent payment to itself, vendors and/or contract parties.

Unlike in bankruptcy, a receiver's fees (and its counsel's fees) do not have to be approved before each periodic payment is made. Assuming an order has been entered approving retention of counsel and the rate of the receiver's compensation, then the receiver can pay itself and its lawyers without further court approval. The receiver then reports to the court in its receiver's report when and how much was paid. In addition to the obvious expediency of this procedure, there is another advantage. As there is typically no detailed bill submitted to the court, the company's competitors do not have a chance to peruse the bills of the receiver and its counsel in an attempt to gather proprietary information to aid them in competition with the defendant's (and now receiver's) businesses.

D. Sale of Receivership Assets.

The method and terms of sale of receivership assets are subject to approval of the receivership court. A sale of receivership assets can be on any terms and conditions set by the court and, as a general matter, is only reviewable for the grossest abuse of discretion. *See Rossi v. Colorado Pulp & Paper Co.*, 88 Colo. 461, 299 P. 19 (1931).

As a practical matter, in most jurisdictions, the receiver should set forth specific sale procedures, including the methodology to be used in soliciting and collecting bids, and determining the highest and best offer for the assets to be sold. The receiver should file a motion, on notice to creditors and parties in interest, seeking court approval of the sale procedures.

The law varies from state to state regarding whether a receiver can sell assets free and clear of liens, claims and encumbrances absent consent or satisfaction of such claims. *See, e.g., Frye v. MacWilson*, 39 Ohio App. 158, 177 N.E. 232 (1931); *Novor v. Fourth St. Bargain Store Co.*, 16 Del. Ch. 259, 145 A. 119 (1929); N.J. Stat. Ann. 14A:14-7 (receiver may sell assets free of encumbrances only if sale may be reasonably expected to benefit general creditors of the corporation without adversely affecting the interests of the holders of the encumbrances); *In re Valley Road Sewerage Company*, 685 A.2d 11, 18 (N.J. Super. 1996) (receiver can sell assets free and clear of liens satisfied from sale proceeds); *Bogosian v. Foerderer Tract Committee*, 264 Pa. Super. 84, 9b, 399 A.2d 408, 414 (1979) (receiver can sell assets free and clear only if there is a "reasonable prospect" that a surplus will be left after the sale for use by the general creditors); *but see* Md. Code Ann. Corps. & Ass'ns, § 3-418 (absent agreement otherwise, receiver can sell (a) equity of redemption or (b) only what could be sold absent insolvency proceeding).

In a federal court action, sales of assets by a receiver are governed by 28 U.S.C. §§ 2001, 2002, and 2004. According to the Ninth Circuit, the right to sell estate assets is within the scope of a receiver's complete control over receivership assets under §754, a conclusion firmly rooted in the common law of equity receiverships. *S.E.C. v. American Capital Investments, Inc.*, 98 F.3d 1133, 1144 (9th Cir. 1996).

A federal court receiver may sell real property by either public or a private sale. A public sale must occur in the district where the receiver was appointed, unless otherwise approved by the court. In addition, the terms and conditions of the sale will be as directed by the court. 28 U.S.C. §2001. The court must approve the form of notice of any public sale, and such notice must be published at least once a week for four weeks prior to the sale. 28 U.S.C. §2002.

Real property may be sold by private sale if the federal court determines that such private sale is in the best interests of the estate. Just like a public sale, the terms and conditions of the sale are set by the court. In a private sale, however, the court must appoint three disinterested appraisers to appraise each parcel of property. The private sale of real estate will not be confirmed by the court unless the sales price is at least two-thirds of the property's appraised value, or if a competing offer for the property is received in an amount at least 10% greater than the amount of the original offer. Notice of a proposed private sale must also be approved by the court and published in a

newspaper of general circulation at least ten days prior to the hearing on the confirmation of the sale. 28 U.S.C. §2001. The sale of personal property is governed by the same rules as that for the sale of real property, unless the court orders otherwise. 28 U.S.C. §2004.

Federal courts appear to be liberal with respect to receivership sales. A judicial sale "made with notice and in the manner prescribed by law will not be denied confirmation or be set aside for mere inadequacy in price unless the price is so gross as to shock the conscience of the court, coupled with slight additional circumstances indicating unfairness such as chilled bidding (citations omitted)." *Breeding Motor Freight Lines, Inc. v. Reconstruction Finance Corp.*, 172 F.2d 416, 424 (10th Cir. 1949). Further the United States Court of Appeals for the Third Circuit, in *Tanzer v. Huffines*, 412 F.2d 221 (3d. Cir. 1969) upheld the expedited sales of corporate property by a receiver which did not comply with the statutory appraisal and notice requirements due to the extraordinary circumstances of the case and the poor financial condition of the company.

Before enactment of Bankruptcy Code section 363(f) in the Bankruptcy Reform Act of 1978, there was no express statutory authorization for federal bankruptcy courts to authorize sales free and clear of liens. Nonetheless, in equitable receivership proceedings, federal courts had the inherent power to foreclose liens through free-and-clear sales. *See First Nat'l Bank v. Shedd*, 121 U.S. 74 (1887).

The processes for sales by a receiver and under section 363 of the Bankruptcy Code appear similar, both requiring court approval of the sale process, as well as the ultimate terms of sale. However, depending on the state in which the action is pending, or whether the action is pending in federal court, a receiver may not be able to sell assets free and clear of liens, claims, and encumbrances as a bankruptcy trustee can under section 363 of the Bankruptcy Code.

E. <u>Distribution of Assets.</u>

The priority of claims in a receivership proceeding is, generally, similar to that under the Bankruptcy Code. The order of distribution is generally as follows, subject to idiosyncrasies of individual states:

> First, court-approved costs and expenses of administration of the receivership estate;
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> Second, secured claims;
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> Third, priority claims;
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> Fourth, general unsecured claims; and
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> Fifth, claims of stockholders/equity holders.

See, e.g., N.J. Stat. Ann. 14A:14-21; N.Y. Debt & Cred. Law §§ 30-38; *see also* 8 Del. Gen. Corp. Law § 300 (wage earners entitled to priority claim for unlimited amount); Md. Code, Comm. Law § 15-102(b) (each of the following constitute priority claims to varying extents: certain wages and health, welfare, and pension contributions; certain

perfected and recorded liens of governmental units and judicial liens on defendant's property; deposits up to $900 for purchase, lease, or rental of property or purchase of services for personal, family or household use; certain rent for interest in real property; certain common carrier charges for transportation of goods); 39 Pa. Cons.Stat. § 95 (priorities under Insolvency Act determined by state statutes regarding execution on judgments).

After the receivership assets have been collected, and the status and priority of all claims have been determined, the receiver should seek an order approving distribution to creditors. All creditors and parties in interest that have filed claims are entitled to notice of the receiver's request for approval of distribution of assets. Upon the Court's approval of the receiver's intended distribution, the receiver pays claims in order of priority to the extent funds are available.

V. SUMMARY OF THE PROS AND CONS OF RECEIVERSHIPS VERSUS BANKRUPTCY PROCEEDING.

A. The Pros of Receivership.

A receivership has several advantages that may not be available in a bankruptcy proceeding. First, a single creditor or interest holder can seek the appointment of a receiver, as compared to the three unsecured creditors generally required to commence an involuntary bankruptcy proceeding pursuant to Bankruptcy Code section 303. Seeking a receiver, which requires court approval at the outset, may avoid potential liability of petitioning creditors under Bankruptcy Code section 303(i) upon dismissal of an involuntary bankruptcy.

Second, a party seeking appointment of a receiver is able to quickly insert an experienced manager into the troubled company who can promptly stabilize the company, stem losses, and stop any decline in asset value. Depending on the circumstances of the case, the receiver can be appointed promptly upon request of the plaintiff, without the need to wait an extended period of time for a hearing.

Third, because there are fewer procedural rules and statutory regulations, there is greater flexibility within a receivership than a proceeding under the Bankruptcy Code. The relief requested in a receivership proceeding can be tailored narrowly to address the specific concerns of the petitioning plaintiff, the defendant debtor, and the Court. For example, if appropriate under the circumstances, a receiver can be appointed to take possession of and manage a secured creditor's collateral, while permitting the defendant's officers, directors and principals to remain in place to manage the defendant's other assets and businesses. The precise powers of the receiver can also be tailored to address concerns and issues particular to defendant's assets and businesses. This flexibility increases the likelihood that a consensual order can be entered setting forth the identity and duties of the receiver, as well as the assets and businesses subject to the receivership. Further, a properly drafted receiver order can provide the receiver ample authority to take certain actions upon notice the plaintiff and\or defendant without the need for continual court oversight, resulting in a less expensive proceeding than under the Bankruptcy Code.

Fourth, the petitioning plaintiff can identify and recommend an appropriate candidate to serve as a receiver, but not a bankruptcy trustee. While the receiver's identity, duties, and powers are ultimately subject to determination by the court, the petitioning creditor can have significant influence on the court by proposing an independent, qualified and experienced receiver and a form of receiver order granting authority in a manner consistent with the creditor's ultimate goals.

Fifth, because receiverships are not as widely understood as bankruptcy petitions, the negative connotations arising from appointment of a receiver may not be as great as the stigma of being a bankruptcy debtor. This may make post-appointment dealings with vendors, customers, and others a bit easier than in a bankruptcy proceeding.

B. The Cons of Receivership.

There is a well-developed body of federal bankruptcy law providing a more predictable process than the sparse body of law on receiverships. This predictability has its benefits, but also imposes procedural hurdles that may not be faced in a receivership proceeding.

Appointment of a receiver may require that the petitioning plaintiff to establish cause, in one form or another, to displace existing management. Court's uniformly state that appointment of a receiver is not an action to be taken lightly and any petition seeking such an appointment will be carefully scrutinized. In contrast, three petitioning unsecured creditors can force a debtor into bankruptcy without the need to show cause other than insolvency of the debtor.

Further, depending on what law applies, a sale of assets by a receiver may or may not be free and clear of liens, claims and encumbrances as such as sale could be under section 363 of the Bankruptcy Code.

While some parties may feel more comfortable with the relative predictability of bankruptcy, depending on the ultimate goal of the judicial proceeding, a receivership may provide the flexibility and speed to avoid unwanted litigation while accomplishing the goals of the petitioning plaintiff.