Alternatives to Chapter 11

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Executive Summary

- Since 2008, the chapter 11 process has trended toward prearranged and prepackaged bankruptcies in an effort to reduce costs and control the uncertainties inherent in the chapter 11 process
- Nevertheless, distressed participants continue to seek cheaper, quicker, and more certain outcomes where available
- The materials presented today will discuss several bankruptcy alternatives and the circumstances under which they are most often employed
- The materials also seek to compare and contrast the alternatives to one another, and to the bankruptcy process
- The takeaway is that while bankruptcy proceedings are a powerful and comprehensive mechanism, under certain circumstances the alternatives discussed today can provide less complex, less costly, and more flexible solutions.

Pros and Cons of Non-Bankruptcy Alternatives

+

- Less expensive
  - Lower professional fees
- Quicker
- More limited disclosure of sensitive information
- Flexibility
- Narrowly tailored remedies

—

- No ability to assume/assign/reject executory contracts
- No limitation on claims as in chapter 11
- Holdouts
- Predictability of bankruptcy law

The Alternatives

Participants in distressed situations have consistently sought to effect their restructurings in the most economical and expeditious manner available. The quest for savings is balanced against other relevant factors (e.g. efficiency, binding effects, etc.). This has led to participants increasingly availing themselves of private, out-of-court alternatives in lieu of Bankruptcy Code options

Six of the most common alternatives to chapter 11 will be discussed today:

1. *Lender Workouts*
2. *Exchange Offers*
3. *Assignments for the Benefit of Creditors (ABCs)*
4. *Compositions*
5. *Article 9 "Friendly" Foreclosures*
6. *Receiverships*

Why are Companies using Alternatives to Bankruptcy??

- Rising expenses of chapter 11
  - Large number of professionals involved in bankruptcy make it an expensive option
- Inefficiencies and delay
- Increases in litigation in chapter 11 proceedings
- Uncertainty intrinsic to the chapter 11 process
- Amendments to the Code via the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA) have made chapter 11 less attractive
  - Assume or reject non-residential real property leases has been limited to 210 days
  - Bankruptcy Code limits the time during which a debtor has the exclusive right to file and solicit acceptances with respect to a plan of reorganization
- Changed players
  - Participants have become more sophisticated

A Spectrum of Alternatives

HIGH → LOW

Management Continuity

Workout	Exchange Offer	Composition	UCC/Friendly Foreclosure	Assignment for Benefit of Creditors (ABC)	Receivership
Narrower in breadth. Creditors forbear as long as company makes scheduled payments	Narrower in breadth	Creditors forbear as long as company makes scheduled payments	Depends on the circumstances	Assignee, but appointed by the company	Receiver displaces management

Scope of relief

ABC	Receivership	UCC/Friendly Foreclosure	Composition	Exchange Offer	Workout
Liquidation and distribution to creditors	Almost invariably leads to asset sale	Depends on scope of liens to be foreclosed	Only binds those creditors who agree to be bound	Addresses particular debt obligations	Addresses particular debt obligations

Time required to effect relief

Exchange Offer	UCC/Friendly Foreclosure	Receivership	Composition	ABC	Workout
Min. 20 business days + negotiation and documentation time. Registered exchanges take even longer	In addition to negotiation period, time to effect controlled by UCC	Appointment of receiver is usually relatively quick, although liquidation of property takes longer	Negotiations may take place relatively quickly	Process is faster and less formal. Assignee must enter into a bond within 30 days of appointment	Friendly workouts can be executed quickly

LENDER WORKOUTS

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The Mechanics

- A bi-lateral consensual out-of-court restructuring through which a financially distressed company and its lender(s) reach an agreement for adjusting the company's credit facility obligations
  - Adjustments are bespoke to the circumstances, but could involve any/all of (i) deferral of interest or principal, (ii) maturity extensions, (iii) covenant relief and/or (iv) debt-for-equity swaps, or some combination thereof. This might call for (a) asset dispositions, (b) the granting of additional collateral, (c) operation benchmarks, (d) financial reporting requirements, etc.

Advantages and Disadvantages of Lender Workouts

Pros

- Cheaper
- Avoidance of the potential stigma of harmful disclosure
  - Chapter 11 requires disclosure of assets, liabilities, and financial affairs
- Simplicity
  - As opposed to chapter 11, which forces all parties to the table

Cons

- Relief is narrower than other alternatives given the bi-lateral nature of workouts

When Might a Workout be the Best Option?

In situations involving moderate or episodic financial distress

When lenders maintain reasonably high confidence in management and/or ownership

EXCHANGE OFFERS

What is an Exchange Offer?

- An out-of-court transaction to recapitalize or reorganize an entity's capital structure
- Offer by the entity to exchange one or more types of debt or equity security for another security
  - Debt for Debt
    - More senior
    - Lower principal amount with higher priority
    - Additional protections
  - Debt for Equity
- Often transfers control or equity to creditors

When is an Exchange Offer used?

- Generally used to eliminate one or more specified classes of securities
  - Eliminate impending maturity date (debt instrument or mandatorily redeemable preferred stock)
  - Cure a default by taking out a debt instrument
  - Satisfy financial covenants in other debt instruments
  - Comply with minimum equity capital requirements of regulators
- Often used when there is a simple capital structure with small number of constituents negotiating and majority consent is not an issue
- Have enough time (no pending event) or liquidity runway to execute
  - No operational issues exist that may need bankruptcy rules to fix (e.g. leases/contracts, CBA/employee agreements, pension or OPEB obligations, vendor debt, etc.)

An Exchange Offer can be ***Debt-for-Debt*** *or* ***Debt-for-Equity***

Debt-for-Debt Exchange

- May take the form of the same or similar form of existing debt (e.g. secured-for-secured or unsecured-for-unsecured)
- Or may take the form of a more senior security which adds protections or enhancements to exchanged debt (often times unsecured debt exchanged for less principal amount of secured debt with priority liens)
  - Popular method as beneficial to both holder and company
- May have a longer maturity life than original security
- Must be allowed by company's other debt instruments and applicable regulatory authorities

Debt-for-Equity Exchange

- Typically targets acceptance by 90% of class of securities being offered for exchange
- If cash is objective of the majority, equitization may not occur
- If control is objective then amount of equity is important (can be common stock, preferred stock, convertible preferred stock or a combination)

Choice depends on the ***objective*** *of security and covenant holders*

How is an Exchange Offer Structured?

- An Exchange Offer is usually combined with solicitation of consent to amend existing debt
  - "Strip" covenants and events of defaults as much as possible without 100% lender consent
  - Purpose of exit consent is to entice participation of holdouts with unfavorable agreement
  - Holdouts are left with a debt security with the payment terms intact that has no covenants or other protections
  - The remaining outstanding securities are illiquid
- Holders of outstanding securities cannot be expected to waive covenants without some benefit in exchange
  - Incentive provided: cash payment, interest rate increase

Cont'd

- The exchange of one security for another may require registration with the SEC (costly and time consuming: 60-120 days)
  - The exchange of bonds for different bonds or bank debt generally requires registration or exemption from registration
- SEC Act § 3(a)(9) requirements for exemptions to register:
  - Same issuer on old and new securities
  - No payment of old security except new security
  - No person paid for soliciting exchange

Advantages of Exchange Offers

- Cheaper and faster than a bankruptcy
  - No judicial oversight
  - No official committees
- Avoid potentially adverse effects of filing
  - Preserve credibility with customers and accordingly revenue
  - Avoid competitors shopping for company's customers
- Limited operational disruption
- Less public disclosure required, preserves confidentiality
  - Extensive disclosure required by chapter 11
  - May avoid vendor backlash

Cont'd

- Fewer constituents participate
  - No official committees and accordingly no committee professional fees or US Trustee fees
  - Operations continue and management/board decisions are made without requiring court approval
- Management is not at risk of being replaced by an examiner or Trustee
- Typically preserves meaningful equity value for existing holders
  - In a chapter 11, equity is often wiped out unless holders invest new money

Disadvantages of Exchange Offers

- Exchange offers do not work well with many classes of debt or large number of equity holders
  - Holdouts, re-trading and large targets for acceptance
- Do not address near term liquidity, as savings are typically reduced by prospective interest expense
  - Banks are often hesitant to lend to financially troubled company without the assurance that a DIP provides

Cont'd

- No protection from other creditors
  - Absence of an Automatic Stay
    - Actions by creditors and litigation proceed unabated
- Debtor needs to continue paying all creditors or be subject to collection efforts, eviction procedures, foreclosure, etc.
  - No operational fixes

Cont'd

- Unfavorable tax consequences that may be avoided in bankruptcy
  - Cancellation of Debt Income (CODI), Original Issue Discount (OID)/Debt for Debt exchange can create OID, Net Operating Loss (NOL) limits from change of control
- Registration requirements can impede speed and cost savings
  - Finding an exemption is important
- Risks inherent in bankruptcy:
  - Preference or fraudulent conveyance actions are risky

ASSIGNMENTS FOR THE BENEFIT OF CREDITORS

Assignment for the Benefit of Creditors ("ABC")

- An assignment for the benefit of creditors is an insolvency proceeding governed by state statutory or common law
- Laws vary from state to state, but for the purposes of this panel we will focus on ABCs under New York law
- ABCs in New York are governed by New York Debt. & Cred. Law §§ 2-24
- An ABC is akin to a chapter 7 bankruptcy proceeding whereby an assignee, instead of a bankruptcy trustee, takes control of the debtor's assets, liquidates them and distributes the proceeds to creditors
- The assignee is not court-appointed as in a chapter 7 case. Rather, the company's officers, or in the case of a partnership, the members, (with guidance usually from the bank, secured lender, or liquidating agent) choose the assignee

Cont'd

- The parties then enter into a common law contract for the assignee's services. Although typically an accountant or an attorney, there is no requirement for an assignee to be either
- Once the assignment is made and accepted by the assignee, debtor's management loses the ability to control decision making over assigned assets
  - See Charles R. Dougherty, et al., *Concurrent Session: Is There a Better Way? Alternatives to Bankruptcy Liquidations and Reorganizations* at p. 4, Am. Bankr. Inst. (Jul. 12, 2012).

Advantages of an ABC

- Management autonomy: assignee is selected by the company
- Less notoriety than a bankruptcy filing; provides for a more discrete wind down of a business
- Process is usually faster, less formal, and requires fewer court hearings…
- In states where court approval of asset sales is not required, a sale pursuant to an ABC can be pursued more quickly than a § 363 sale
  - However, note that in New York, court approval of sales is required
  - In New York, ABC sales require at least 10 days' notice as opposed to the standard 21 days' notice for a § 363 sale
    - However, where cause exists, asset sales pursuant to § 363 of the Bankruptcy Code can be consummated on shortened notice
      - For example, in *In re Lehman Bros. Holdings, Inc., et al.*, the Order Authorizing the Sale of Assets was approved on 9/20/2008, only five days after Lehman filed for bankruptcy. Chapter 11 Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. 2008).

Disadvantages of an ABC

- An ABC does not discharge debts; thus, it is only typically used by corporations as opposed to individuals and partnerships
- A buyer of an assignor's assets does not obtain "clean" title and takes title subject to liens, unless the lienholder releases its liens
- Less transparency than in a bankruptcy filing
- There is no automatic stay of litigation
- Creditors may attempt to "undo" an ABC or any sale of assets by filing an involuntary bankruptcy proceeding against the company

What are the duties of the Assignee?

- An assignee functions much like a chapter 7 trustee in that the assignee:
  - Notifies creditors of potential distributions;
  - Marshalls the assignor's estate;
  - Objects to claims;
  - Files interim and final reports with the court; and
  - In New York, has the power to bring avoidance actions. N.Y. Debt. & Cred. Law § 15

Bond Required by Assignee

- Similar to a bankruptcy trustee, within 30 days of his or her appointment, an assignee is required to enter into a bond to the people of the State of New York, in an amount to be ordered and directed by the judge, with sufficient sureties to be approved of by such judge. N.Y. Debt. & Cred. Law § 6.
- The bond shall be filed in the clerk's office of the county where such assignment is recorded. *Id*.

Notice Requirements

- At least ten days notice to creditors and parties in interest is required for:
  - all proposed sales of property;
  - the declaration and time of payment of dividends;
  - the filing of the interim account and the filing of the final account of the assignee and of the hearing thereon; and
  - the proposed compromise of any controversy.

N.Y. Debt. & Cred. Law § 12.

Procedural Aspects of ABCs Under New York Law

- File and record the deed of assignment for the benefit of creditors
  - Deed is filed in the county clerk's office in the county where such debtor shall reside or carry on his business at the date thereof. For a corporation or co-partners, an assignment is recorded in the county where the principal place of business is situated. N.Y. Debt. & Cred. Law § 3.
- In New York County the deed is filed at the State Court located at 60 Centre Street, New York, New York
- Within 20 days of the Omnibus Order being approved by the State Court, the assignor must file an inventory of assets with the county clerk and deliver a schedule of assets to the assignee. N.Y. Debt. & Cred. Law § 4.

Procedure *cont'd*

- File Omnibus Order to Show Cause and Petition
  - The Omnibus Order (a) commences the ABC and sets the amount of the assignee's provisional bond, (b) authorizes the assignee to sell assets, and (c) authorizes the publication of a legal notice in the Law Journal setting the date of the auction
  - In addition, the assignee should request authority to advertise for claims in the same publication notice. The petition should also include a notice of appearance for the attorneys for the assignee and retention language for those attorneys
  - At the end of the proceeding, an Order to Show Cause to Judicially Settle Assignee's Final Account is prepared and submitted along with any applicable fees or applications for fees and expenses by professionals retained in the case

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Cont'd

- The Order to Show Cause, the Assignee's Final Account, and any Fee Applications prepared by assignee's professionals must all be reviewed and approved by the Court
- Once the Order to Show Cause to Judicially Settle Assignee's Final Account has been executed, the assignee will serve the notice on all creditors of the date and time of hearing to approve the Final Account and all relevant fee applications

Filing of Claims and Objections

- The assignee may petition the Judge for a bar date by which all creditors must submit their claims
- A minimum of ten days notice of a claims bar date is required

N.Y. Debt. & Cred. Law § 5.

Order of Priority of Claims

- Once the assignee has sold the assets and costs of administration have been paid, the N.Y. Debtor and Creditor Law provides priority claims only to the following:
  – Debts due to the United States;
  – Taxes due to New York State;
  – Employee contributions to retirement systems or plans;
  – Wages and salaries owed to employees within three months prior to the assignment, not to exceed $1,000 to each employee; and
  – Cash deposits made for retail purchases of merchandise or services within six months of the assignment, not to exceed $300 each

N.Y. Debt. & Cred. Law §§ 21-a, 22(1).

Assignee and Professional Fees

- The assignee's commission shall not exceed 5% of the whole sum which will have come into his or their hands
  – If the assignee continues the business the court may allow him additional compensation equal to what he might be allowed as hereinabove provided
- The actual and necessary expenses incurred by the assignee in the administration of the estate shall be reported in detail, under oath, and examined and approved or disapproved by the court. If approved they shall be paid out of the estate
- The Court must approve any fees and expenses sought by professionals retained by the assignee

N.Y. Debt. & Cred. Law § 21.

COMPOSITION AGREEMENTS

What is a Composition Agreement?

An out-of-court negotiated contractual agreement between a debtor and its creditors, usually unsecured, whereby the creditors agree to accept a less favorable claim against the debtor in order to reorganize and rehabilitate the debtor

Composition Agreements

To be enforceable, a composition agreement requires consideration and only binds those creditors who agree to it. Creditors who do not sign on to the agreement retain their original rights and claim

Akin to an out of court restructuring plan, a composition agreement is less expensive and less time consuming than negotiating a plan pursuant to a formal bankruptcy process. It also enables a company to avoid the stigma and "bad press" associated with a bankruptcy filing

When is a Composition Agreement Best Utilized?

- When:
  - a business is viable and can be saved;
  - there is a small creditor body with which to negotiate;
  - the debtor has a strong established relationship with its creditors and;
  - when the terms or concessions needed to save the debtor are not too complicated or onerous.

Typical Provisions Included in a Composition Agreement

- The background of the debtor's financial condition and terms of the compromise;
- The percentage of creditors required for the agreement to be effective;
- A provision to deal with disputed claims;
- An agreement by the creditors not to file a bankruptcy petition, absent certain default triggers in the agreement itself…;

Cont'd

- The designation of an escrow agent and creditors' committee;
- Applicable default provisions and remedies upon default;
- Reservation of rights allowing creditors to assert their full claims in the event of default;
- Subordination of insider loans; and
- Standard contractual provisions such as choice of law.

See Comm. on Bankruptcy & Corporate Reorganization, N.Y. City Bar, *Non-Bankruptcy Alternatives to Restructurings and Asset Sales* at pp. 20-21 (Nov. 2010).

Disadvantages of Composition Agreements

- A debtor does not gain the protection of the automatic stay as under Code § 362 and may be subject to suits, attachments, and be at the mercy of its creditors who may file an involuntary bankruptcy petition
- Compositions require a high percentage of creditors to sign onto the agreement and creditors cannot be forced to accept the agreement, unlike in bankruptcy where Code section 1129(b)(1) can be used to "cram down" a plan on a rejecting class of creditors
- Harder to use in today's distressed debt market

Conclusion

- Although limited by the size, creditor body, and goal of the debtor, ABCs and Composition Agreements provide worthwhile alternatives to the expensive and time consuming bankruptcy process
- That notwithstanding, it is imperative for attorneys to evaluate the needs of their clients and whether the protections offered under the Bankruptcy Code—such as the automatic stay and ability to sell assets "free and clear"—outweigh the burdens of chapter 11
- Practitioners should also be mindful of the oversight and predictability offered of an established bankruptcy bar and bench

'Friendly Foreclosure' and

UCC Article Nine Sales

What is a 'Friendly Foreclosure'?

- Akin to a § 363 Sale – a transaction in which a secured creditor's right to foreclose its collateral by way of a public or private sale under the UCC or other applicable law.
  - It is termed "friendly" when a financially challenged borrower willingly cooperates with its unsecured lender to facilitate a foreclosure sale.
- Other terms: "Secured party sale," "Article 9 Sale," "UCC Foreclosure" etc.
  - Note that not all secured party/Article 9 sales are "friendly"

UCC Article 9

- § 9-610: provides that a secured party may sell or otherwise dispose of collateral
  - § 9-610(a): foreclosure must be "commercially reasonable"
  - § 9-610(b): elaborates on concept of commercial reasonableness

Differences from Code § 363

- Quicker and cheaper – lower professional expenses
- Limited Scope – deals with creditor's collateral and junior liens on collateral, but NOT unsecured claims against the loan parties

"Commercial Reasonableness"

- A disposition of collateral is "commercially reasonable" if it is made:
  - In the usual manner on any recognized market;
  - At the price current in any such market at the time of disposition; or
  - Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition
- § 9-627(c) states that "A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved:
  - In a judicial proceeding;
  - By a bona fide creditors' committee;
  - By a representative of creditors; or
  - By an assignee for the benefit of creditors."
- Downside: Uncertainty. UCC sales do not carry the certainty of sale procedures, purchaser, and price as does a § 363 process

Public v. Private Sales

- Under the UCC, collateral may be sold at either a public or private sale.
- Per § 610(c), a secured creditor may purchase collateral at a public sale. In a private sale, purchase may occur only if the collateral is of a specific type
  - i.e. "of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations"

What does it mean?

By restricting a secured creditor's right to purchase its collateral to either a public sale, or a private sale of property with a readily ascertainable market price, the UCC attempts to protect debtors from creditors who might use the foreclosure sale to seize collateral worth more than their debt or at a depressed valuation

§ 363 v. Article 9: Realizing Value

VALUE

§ 363	Art. 9
§ 363(f): "the trustee may sell property …*free and clear* of any interest in such property…"	UCC disposition transfers all of debtors' rights in collateral and discharges the foreclosing secured creditors' lien and any subordinate security interests.
→ Makes assets more attractive to the buyer and thus achieves a higher price ←	§ 9-610(d)-(e) permits the selling secured party to market assets without meaningful reps and warranties.
	→ Allows for a quick, flexible sale, but perhaps at the expense of maximizing price ←

VALUE

Notice

- The UCC provides detailed notice provisions intended to ensure that the debtor, lienholders, et al. are made aware of the foreclosure
- § 9-612(b) defines reasonable notice as 10 days or more before the earliest disposition
- § 9-611(c)(3)(B) and (e) provide that a secured party likely must take specific steps to compile its notice list at least 10 days before giving notice.
  - In concert with § 9-612(b), § 9-611(c) substantively extends the notice period longer than ten days.

Deficiency and Surplus Claims
UCC § 9-615

The UCC also specifies how the proceeds of a sale are allocated and how any deficiencies or surplus is addressed

- 9-615(a)
  - Secured party may be reimbursed for reasonable expenses of the sale plus legal fees.
- 9-615(d)
  - Obligor receives any surplus and remains liable for remaining deficiencies.
- 9-615(f)
  - Provides that if a disposition is to a party related to the secured party, then the deficiency must be calculated as if the disposition was to an unrelated party.
    - i.e. **Prevents self-dealing**

Strict Foreclosure

- UCC § 9-620 and § 9-621 provide for the secured party to take direct possession of collateral
  - "Partial Strict Foreclosure": if a secured party takes possession of collateral but still has a deficiency claim
    - Requires debtors' consent
  - "Complete Strict Foreclosure": Same as above, but if there is no deficiency claim
    - Requires non-objection from debtor (objection period is 20 days from date of notice)

How is Foreclosure different from a liquidation?

- Friendly foreclosures are a common method of cooperatively liquidating a failed business, but can also be used as a way to quickly implement a restructuring
- How can a foreclosure look different than a liquidation?
  - If managers and employees retains their jobs and other performance incentives
  - If the lender provides financing for the new entity
  - In some instances, stockholders may even participate in the restructuring by receiving new equity

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Situations in Which a Friendly Foreclosure Might be Most Successful

- Where managers and employees desire to remain part of the going concern
- Where the secured lender wants to retain a high degree of control over the turnaround
- When the debtor recognizes that (i) pledged assets must be sold, (ii) that reorganization prospects are dim, (iii) potential unsecured claims are known and simple, and (iv) that there is no need for a court order disposing of assets free and clear of existing liens
- Where there is little to no unsecured debt or where the buyer is assuming such debt

Conclusion

- In general UCC "Friendly Foreclosure" provides secured creditors with a state law remedy to control or sell collateral securing their debt
- Foreclosure is often less expensive and more expedient than the § 363 bankruptcy alternative
- Friendly foreclosure also provides an effective manner to address unsecured claims, and provides more certainty to the parties in the sense that there is minimal risk of subsequent bankruptcy proceedings
- A disadvantage is that "free and clear" sales in bankruptcy are significantly broader

Receiverships

What is a Receivership?

- A receivership is an equitable remedy under state or federal law in which a court-appointed fiduciary (a "receiver") takes charge of, preserves, and manages property that is the subject of an ongoing legal dispute
- Receiverships are an ancient equitable remedy popularized in Elizabethean England as a method of preserving and managing property in situations where the owner was incapable of caring for it
- Today, receiverships are often viewed an "extraordinary remedy"
- "Absent consent, a receiver will only be appointed by a court upon a showing of *waste, fraud, gross mismanagement, or other special circumstances*, such as a risk of loss to the property during the protracted litigation."
  - Sharon B. Zuch. *Alternatives to Franchisee Bankruptcy: Workouts, Compositions of Creditors, Assignments for the Benefit of Creditors, and Receiverships*. 33:3 Franchise L.J. 359-75 (2014).

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Types of Receiverships

General Receiver

- The general receiver is analogous to a bankruptcy trustee. The receiver:
  - Controls all the assets;
  - Operates the business with the intent to either sell assets as a going concern or liquidate the assets of the business; and
  - Displaces the business' management

Special Receiver or Limited Receivership

- The receiver only takes possession of designated assets and/or businesses
  - The debtor's remaining assets and businesses stay in the possession of the debtor
- The receiver has no authority over components of the debtor's businesses that are not subject to the receivership

Authority for Appointing a Receiver

- A receiver may be appointed under:
  - State statutes and/or common law;
  - Federal statute (Fed. R. Civ. P. 66) and/or common law
- State Court Authority:
  - A majority of states have enacted statutes authorizing the appointment of a receiver under various circumstances
    - See N.Y. Bus. Corp. Law §§ 1201, et seq.; N.Y. Not-for-Profit Corp. Law §§1201, *et seq.*
    - See Del. Code Ann. tit. 8,§§ 226, 291
  - Although generally viewed as a drastic remedy, no uniform standard is applied across jurisdictions; rather the power to appoint a receiver rests in the equitable power of the court

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Cont'd

- Federal Court Ancillary Jurisdiction:
- Fed. R. Civ. P. 66:
  - (i) the Federal Rules of Civil Procedure govern an action in which the appointment of a receiver is sought or a receiver sues or is sued;
  - (ii) the practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts or with a local rule; and
  - (iii) an action in which a receiver has been appointed may be dismissed only by court order
- If the underlying action is pending federal court, the court must have federal subject matter jurisdiction over the receivership
  - Once established, jurisdiction extends to any judicial district in which receivership property is found, provided that the federal receiver files copies of the complaint and order within ten days of appointment, in each district in which receivership property is located. 28 U.S.C § 754.
    - Failure to file such copies in any district divests the receiver of jurisdiction and control over property in that district

Factors Considered in Appointing a Federal Receiver

- Appointment of a federal receiver is an extraordinary remedy and is granted only in cases of ***clear necessity*** to protect a plaintiff's interest in property
- Courts consider a variety of factors when weighing the necessity, including:
  - The existence of a valid claim of the moving party;
  - Fraudulent conduct on the part of the defendant debtor;
  - 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;
  - The plaintiff's probable success in the action; and
  - The possibility of irreparable injury to plaintiff's interest in the property
- A court will not appoint a receiver in equity unless it is ancillary to some form of final relief which is appropriate for equity to give

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Selecting a Receiver

- The petitioning plaintiff may select any person or entity it believes is best suited to manage the receivership assets, subject to court approval
  - Receiverships are particularly attractive to creditors in this regard, as the creditor is able to hand select the party overseeing and administering the receivership proceeding
- Because there is no debtor-in-possession in a receivership, owners and management lose control of the company and become the receiver's employees
  - Often, receivers will appoint an officer to assist with day-to-day operations of the business
  - It is, therefore, important to select a receiver with adequate knowledge and experience to run the business

A Receiver's Authority to Act

- A receiver is not autonomous
- A receiver, whether in a state or federal case, is an officer of the court
  - A receiver's fiduciary duties run to the *court only*; not to any particular creditor, not to the defendant debtor, and not to any other party in interest
- A receiver derives its authority to act, and its rights and its obligations solely pursuant to a "receiver order" entered by the court
  - The parties draft the receiver order and can negotiate the scope of the receiver's authority and management powers
  - The receiver acts only under judicial direction and supervision, and receives compensation only as the court orders

Administration of Receivership

- The appointment of a receiver puts all the property subject to the receivership in the custody of the court
- Various statutes require the receiver to notify creditors and interested parties of the receiver's appointment
  - With respect to a federal court action, a receiver must file copies of the complaint and the order appointing the receiver in each district in which receivership property is located
- Equitable Stay – there is no automatic stay in receiverships as there is in bankruptcy, but 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, or (c) compel discovery, and/or seeking similar relief
  - Similarly, a receiver may sidestep some litigation by obtaining a court order that (a) sets a short deadline to present and file claims and (b) requires creditors to dismiss other claims as a condition to participation in the receivership proceeding

Receivership v. Bankruptcy – Advantages for Creditors

- Only one creditor is needed for a receivership (involuntary bankruptcy requires three)
- Less expensive than bankruptcy
- Ability to quickly replace ineffective management
- More flexibility than the Bankruptcy Code because there a few procedural rules and statutory regulations
- Creditors can narrowly tailor the relief requested in the proceeding to address concerns and needs of the particular business
- The powers of a receiver can be modified to allow certain actions, such as asset sales, without continuous judicial oversight
- Petitioning creditor selects and recommends the receiver to the court, which can result in the alignment of the receiver's authority with the creditor's goals
- 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

Receivership v. Bankruptcy – Disadvantages for Creditors

- Necessity to establish cause to appoint a receiver
- Scope of property of the estate under the Bankruptcy Code is much more expansive
- No Automatic Stay
- Asset sales may not be "free and clear" of liens, claims and encumbrances
- Bankruptcy law is well developed and more predictable
  - Federal bankruptcy judges have more power than state court judges and can exercise jurisdiction over any assets of the debtor located anywhere in the United States
- Removal of existing management is not always desirable
- No formal plan of reorganization or procedural safeguards associated with plan confirmation
  - No cramdown provisions for dissenting creditors
  - No DIP financing
- Distribution of assets not statutorily proscribed

Conclusion

While a bankruptcy proceeding is a powerful and comprehensive mechanism, under certain circumstances, the alternatives presented today can provide a ***less complex and less costly solution****.*

In other circumstances however, these alternative procedures are outweighed by the advantages presented by a **formal judicial process.**

At a minimum, practitioners should familiarize themselves with these innovative alternatives and consider them before commencing a formal bankruptcy proceeding on behalf of their clients.