Body of Knowledge

LEGAL PRINCIPLES

TMA Institute
LESSON 6
Alternatives to Bankruptcy: Receiverships and ABCs
Bankruptcy may not always be the best or least costly answer to resolving a business entity’s financial difficulties. There are two other methods commonly used outside of bankruptcy: receiverships and assignments for the benefit of creditors (ABCs). These alternatives offer procedural flexibility and lower costs, which are especially important to smaller companies.

**Receiverships**

Receiverships can be initiated under either federal or state law. In order to qualify under federal law, the federal court needs to have jurisdiction, which usually means diversity such as having assets in more than one state. Therefore, most receiverships are brought in state court, which may be controlled by state statutes, common law, or both. While receiverships are popular for real estate, they can be used for any business entity needing oversight or liquidation. Secured lenders will use receivership to gain control of the assets when attempting a foreclosure or have lost trust in the business entity’s management. Receiverships can also be used when owners or management are in a deadlock and an outside third party is needed to take operational control.

**The Process**

Receiverships begin with one party filing a lawsuit against the business entity and then filing a motion asking for the court to appoint a receiver. The complaint may be filed by a creditor seeking recovery of its debt, a governmental agency seeking to enforce its regulatory powers, or by another party such as a co-owner seeking to get managerial control turned over to an outside third party.

**Required Showing**

The appointment of a receiver is typically considered an extraordinary equitable remedy, which rests with the discretion of the court. Often, a hearing will be held to determine whether a receiver should be appointed, particularly if the debtor contests the appointment of a receiver. The standard for determining whether a receiver should be appointed will depend on whether the appointment of a receiver is sought under a specific statute or under the court’s general equitable powers. The general criteria for a receiver to be appointed include fraudulent activity, severe mismanagement, imminent danger to the property involved, or there is the possibility of irreparable injury to the plaintiff’s interest in the property.

**Who Can Be a Receiver**

Generally, the receiver is an independent professional brought in to operate and manage a business or income-producing real estate or to oversee the liquidation of the business. While the courts generally adopt the recommendation of the party seeking appointment of a receiver, the courts may choose the receiver or someone recommended by the company or other parties in interest.
Receiver’s Powers and Duties
In general, a receiver’s powers are limited to the specific property that is the subject of the receivership. Where a secured lender has started a real estate foreclosure proceeding, the receiver will take possession and control over the real estate for the benefit of all interested parties. In the case of a business entity, if the party seeking the receiver shows that all property of the company is at risk, or if the company consents to the appointment of a receiver for all property, the order appointing the receiver may be drafted broadly to cover all of the business entity’s assets.

The receiver’s powers stem from the court order, making them an officer of the court. Typically, the receiver’s power is to take possession of the business entity’s assets and managing them in the best way possible for all interested parties. The receiver acts as a fiduciary for the receivership estate and answers to the appointing court. Once the receiver has been appointed, prior management and owners no longer have any authority over the assets in receivership.

If it is anticipated that the receiver will sell estate property, the order appointing the receiver should specify the scope of the receiver’s authority to sell property and any limitations on that authority. The order appointing the receiver may be drafted so as to authorize the receiver to request that the court enter an order, similar to the order that would be entered in a Bankruptcy Court, authorizing the sale of assets to a purchaser free and clear of liens and claims, with liens and claims to attach to the proceeds. Due process may require that parties who may claim an interest in the property be joined as a party to the underlying lawsuit before the estate property can be sold free of their interests. If a secured creditor does not consent to the sale of their collateral, unlike in bankruptcy, the court does not have the authority to enter an order for sale free and clear of liens and encumbrances.

Receiver’s Personal Liability
A receiver exercising its judicially authorized functions is generally afforded immunity from liability for its actions during the receivership. This immunity would not cover unlawful acts, fraud, or intentional misconduct. Some jurisdictions will allow a receiver to be held personally liable for actions taken in bad faith or outside the scope of the receiver’s authority, or for failure to exercise ordinary care.

At the conclusion of a receivership, there should be an order from the court approving the receiver’s final report and accounting, finding the receiver’s actions were authorized and undertaken in good faith, and, to the extent permitted by the court, releasing the receiver from all liability in connection with the receivership.

Receivership Expenses
The expenses of the receivership, including compensation of the receiver and any professionals retained by the receiver, are paid from rents, sale proceeds or other income generated from operation of the receivership property or business. The terms and conditions of the receiver’s compensation are typically authorized by the court at the outset of the appointment, subject to approval by the secured creditor if using
their collateral, and may be subject to final review and approval at the conclusion of the receivership. If any secured creditor objects to the use of their collateral to pay the expenses of the receivership, the authority and ability of the receiver to use the collateral to fund the receivership will typically be limited.

**Receivership Advantages and Disadvantages**

Advantages of a receivership include flexibility and controlled cost. When the secured creditor and the borrower are in agreement as to what to do, such as sell the business, a receivership can be a simple, appropriate method of achieving that goal. If all parties in interest receive notice of the proposed action, the judge will usually have no objection to entering the requested order.

A receivership can also be a good vehicle to force a recalcitrant company into court, where its operations and financial affairs with respect to the receivership property are subject to the oversight of the receiver and court.

However, there are a number of disadvantages. Because the law on receiverships is less developed than bankruptcy law, there are no defined steps to a receivership, and unlike a debtor–in–possession, the business entity loses managerial and operational control of its assets.

There are also a number of items that could be either beneficial or detrimental, depending on the circumstances. There is no automatic stay in a receivership, which could be beneficial if the business entity wants to continue making payments to its creditors or detrimental if it means the creditors can continue aggressive and harmful collection actions, although as courts of equity, the court can impose stays of actions being brought against the receivership assets. The receiver has no authority to avoid or recover preferential payments as defined in the Bankruptcy Code. On the other hand, fraudulent conveyances made before appointing a receiver do not become public knowledge, which leaves it to the discretion of the receiver whether to pursue recovery in state court. If the business entity is liquidated, the distribution of proceeds is made in accordance with state law, which will not necessarily be in the same order or amount of priority as in bankruptcy—again, it could be a favorable or unfavorable consequence of the receivership. There is no discharge of debt for those liabilities that remain unpaid at the end of a liquidating receivership, which could be irrelevant in the case of a full liquidation.

Because of the discretion of the receiver and potential different outcomes under the bankruptcy laws, there is the possibility of disgruntled creditors filing an involuntary Chapter 7 liquidation, which if successful—except for in very limited situations—will result in the termination of the receiver and a Chapter 7 trustee taking over as liquidator.
Assignment for the Benefit of Creditors

An assignment for the benefit of creditors (ABC) is a method of liquidating a distressed company’s assets, via state or common law, that is often easier, faster, and less expensive than a Chapter 7 bankruptcy. It may also, in certain circumstances, result in higher recoveries for creditors. This process is typically employed in situations where there is either no time nor a possibility of implementing a financial or operating restructuring.

Before undertaking an ABC, the business entity should review its articles of incorporation, bylaws and the laws of the state of its incorporation to ensure the proper corporate, partnership and shareholder authorization is obtained and that the ABC is conducted in accordance with any applicable state law. ABC proceedings can either be under the common law or statutory. In some states, common law ABC proceedings do not involve the courts. The rules related to who may be the Assignee and the powers of the Assignee in those cases is similar to the rules in statutory ABC proceedings.

The Process
The company assigns all of its assets to an independent fiduciary, the Assignee, who conducts an orderly liquidation of the assets and distributes the proceeds to creditors as in accordance with state law. An agreement is executed by and between the business entity and the Assignee, which creates an estate consisting of the transferred assets and proceeds thereof, subject to the claims of the assignor’s creditors. Depending on the practice of a particular state, this agreement may be a contract, deed of assignment, or other similar type of instrument. The transfer of assets is subject to all existing perfected and enforceable liens. Typically, an ABC does not require the consent of creditors because the ABC is considered a trust, with the creditors its beneficiaries. However, depending on the state statutes, the rights of secured creditors may not be affected without their consent, including the use of their collateral to fund the expenses of the ABC. The filing of an ABC may also constitute an event of default under agreements with secured creditors giving rise to the right of such creditors to exercise independent remedies against the company.

Who Can Be an Assignee
The Assignee is typically selected by the business entity’s management or owners, with permission of the primary secured creditor. Unsecured creditors are generally not involved in the process. The Assignee is selected based on independence, objectivity, experience, and any special needs required in the liquidation of the collateral. Some states specify whether the assignee can be or needs to be an individual versus a firm of professionals.

Assignee’s Powers and Duties
Because the assets are transferred to the Assignee in trust, an ABC effectively stops creditors from pursuing the business entity’s assets through collection so an orderly liquidation can occur. The Assignee may operate and sell the business as a going concern or may immediately shut down the business and liquidate the assets.
Provided the secured creditor has consented, the liquidation proceeds generated are first used to pay the Assignee’s expenses, then the secured lenders to the extent of the value of their collateral, and then to the remaining creditors in accordance with relevant state law. It is important to note that there are no free and clear rights, comparable to those available under Section 363 of the Bankruptcy Code, so the Assignee must obtain the consent of any creditors holding perfected security interests or liens in the assets before selling their collateralized assets.

The Assignee has the rights of a lien creditor under Section 9–309 of the Uniform Commercial Code, such that the Assignee’s interest prevails over unperfected security interests. Accordingly, an Assignee may use its lien–creditor status to seek to recover assets from creditors who may have received preferential transfers from the business entity prior to the assignment, pursuant to applicable state fraudulent transfer or preference avoidance laws. Note that distributions are paid in accordance with state law and not bankruptcy law. There could be substantial differences between creditors entitled to priority.

Most ABC statutes do not dictate timing and procedures within the ABC. The Assignee typically notifies creditors of the ABC and requests they submit a proof of claim for liabilities owed and to receive a distribution. Once the assets have been liquidated, the Assignee can make distributions to the creditors. If the liquidation proceeds are insufficient to fully repay all liabilities, the remaining debts simply remain unpaid, unless covered by personal guaranties or officer liability claims.

Payments to creditors pursuant to an ABC are typically not later avoidable as preferential transfers or fraudulent conveyances. Some courts, however, have held that an Assignee cannot condition payment of a creditor’s claim on the creditor’s release of the business entity for the unpaid portion of its debts. To do so is considered a fraudulent conveyance because a creditor would have to accept virtually any condition that the Assignee decided on if the creditor were to receive payment from the Assignee.

**ABC’s Advantages and Disadvantages**

An ABC may be an advantageous alternative to Chapter 7 liquidation for a distressed business with little or no hope of surviving as an operating entity because it is a faster process, has lower administrative costs, and the business entity has the ability to choose, or at least participate, in the selection of the Assignee. Because management and the Board of Directors are not directly responsible for the liquidation process, they can minimize their liability for the process and can step aside as to liquidation responsibilities. Creditors benefit because they are not subject to avoidance liability for preferential transfers for payments received in the ABC and are working with a professional with no personal interest in the outcome.

On the other hand, as with a receivership, an ABC may not be effective for large businesses or businesses with assets in more than one state, or if a business entity’s assets are subject to multiple competing secured lien rights, since an Assignee may not sell assets free and clear of liens. Likewise, the business entity in an ABC does not receive a discharge, and the business entity’s guarantors remain liable on their obligations. Depending on the state statute, the creditors may be subject to claims for preferential transfers that were made prior to the assignment.
Impact of a Bankruptcy Filing on a Receivership or ABC

Neither the appointment of a receiver by a state or federal court nor an assignment for the benefit of creditors preclude the filing of a bankruptcy. There may be an exception when an entity has been placed into receivership by a governmental agency or a receiver is appointed pursuant to a specific federal statute authorizing or requiring a receivership. Upon the filing of a voluntary bankruptcy by the debtor, or an involuntary bankruptcy filing against the debtor, Section 543 of the Bankruptcy Code requires a custodian, such as an assignee or state-court receiver, to turn over to the trustee or Chapter 11 debtor-in-possession all property of the debtor in its control and account for all monies handled during the receivership or administration of the ABC.

The Bankruptcy Court can excuse compliance with this requirement to turn over property if the Bankruptcy Court determines that the interest of creditors would be better served if the receiver continued in possession of the borrower’s property or if an assignee for the benefit of creditors was appointed more than 120 days prior to the bankruptcy filing, unless the court finds turning over the assets to the trustee is necessary to prevent fraud or injustice.

In addition, a party in interest, such as a receiver, assignee, secured creditor, or the debtor, may request that the Bankruptcy Court abstain from exercising jurisdiction over the bankruptcy or suspend proceedings if allowing the receivership or ABC to continue would be in the best interests of creditors and the debtor. For example, it may be appropriate for the Bankruptcy Court to abstain from exercising jurisdiction and allow a receivership to continue if the case is primarily a two-party dispute between the debtor and its secured lender. Likewise, an argument may be made that a small company’s assets could be more cost-effectively liquidated in an ongoing ABC than in bankruptcy. In some cases, however, the established priorities and procedures for administration of claims and broader avoidance powers other bankruptcy-specific rights granted to a bankruptcy trustee may weigh in favor of administration and/or liquidation of the company’s assets through bankruptcy.

Under certain circumstances, it may be appropriate for receiver to file a bankruptcy petition on behalf of the debtor, if the receiver determines that doing so is in the best interests of the debtor, its creditors and other parties in interest, and if the receiver is granted authority to do so by statute or in the order appointing the receiver.

References: