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Receiverships Can Be Efficient Alternative to Bankruptcy

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Jun 14, 2010

(TMA International Headquarters)

Recent bankruptcy decisions such as *Clear Channel Outdoor Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008) and the very recent *In re Philadelphia Newspapers, LLC, et al*, 2010 U.S. App. LEXIS 5805 (3rd Cir. 2010), raise concerns regarding bankruptcy's predictability as an efficient means to sell assets. Accordingly, creditors are demonstrating a renewed interest in state receiverships and assignments for the benefit of creditors as bankruptcy alternatives.

A receiver is a third party that takes control of a debtor's assets under at least nominal court supervision to administer them on behalf of creditors. Rooted in old English law, injunctions against waste and to preserve property were already being issued during Elizabeth I's reign in the 16th century. By the mid-18th century, receivers were clearly in a court's repertoire of remedies. Most states now have several legal processes for appointing a receiver.

A related but distinct concept from receivership is an assignment for benefit of creditors (ABC). *Black's Law Dictionary (4th Ed.)* defines a general assignment for the benefit of

creditors as “a transfer of legal and equitable title to all debtor’s property to a trustee, with authority to liquidate the debtor’s affairs and distribute proceeds equitably to creditors.” An ABC has been held to be an inherent property right existing at common law, independent of statute.

The words “receiver” and “assignee” often are used interchangeably. Originally, an assignee referred to the party to whom a debtor assigned assets and liability for administration—in effect, a trustee—while receivers were court-appointed. In some states, that distinction is still recognized in the assignment documents with a subsequent court petition seeking appointment of the assignee as receiver.

The Uniform Commercial Code (UCC) recognizes ABCs and provides assignees with a perfected lien in the debtor’s property on assignment. U.C.C. Section 9–309 (12) (2005). Receivers’ liens also exist at common law and maintain their vitality and priority, surviving a bankruptcy preference challenge when the lien attaches outside of the Bankruptcy Code’s 90-day preference period.

Evaluating Options

In evaluating options for a legal liquidation process, the objective is to preserve the asset value to pay creditors. To meet this objective, the three primary criteria to consider are cost, timeliness, and ability to transfer clear title. Operational factors, such as minimal court time, flexibility, and process transparency, significantly impact the outcome. Because a Chapter 7 trustee is not authorized to operate a business without express consent, Chapter 11 is the only way to sell a business as a going concern under the Bankruptcy Code, and asset values may diminish during a long and costly sale in bankruptcy. Receiverships generally avoid many of these complications.

In comparing Chapter 11 to receivership, a number of factors should be considered. The Bankruptcy Code provides specific benefits that some state court actions do not. For instance, Bankruptcy Code Section 365 provides specific protections for leases and

contracts, Section 366 establishes a mechanism to address continuing utility service, and nonconsenting secured creditors can be forced to accept a sale. Under some circumstances, the Bankruptcy Code allows a debtor to impose use of cash collateral on an unwilling secured creditor. Receivership law does not permit this. But benefits bestowed by the Bankruptcy Code may not be germane to a specific case, and at times a functional analog exists in some state receiverships for protections afforded by the Bankruptcy Code. Consequently, each case requires unique evaluation.

Bankruptcy Courts have national jurisdiction over necessary parties and property. That is not a given in receivership, though this concern is frequently overstated. Even if there is no personal jurisdiction over the party to whom the debt is owed, 19th century receivership case law holds that a debt owing by a resident of a state provides that state in situ or in rem jurisdiction over the resident's property.

An additional consideration is that the U.S. government may not be bound in alternate procedures. If there are tax issues relating to the U.S. government or a state that is not the jurisdiction where the receivership is being heard, issues may arise in dealing with that creditor. Many times, however, these parties voluntarily participate in the receivership.

Receivership cases typically are heard by a general jurisdiction judge, who may handle other civil matters, and criminal, family, juvenile, probate, and other cases as well. Such a judge may not be as familiar with insolvency law and concepts as would a bankruptcy judge, who presumably is well-versed on the statutes and case law. There is generally not an expansive set of rules and law with respect to receiverships, though there are exceptions (such as Chapter 727 of the Florida Statutes). That has advantages and disadvantages.

There also is no debtor-in-possession in a receivership. Owners and management lose control of the company and become the receiver's employees. This may be an advantage or disadvantage, depending on one's viewpoint.

Receivership Models

Assignments/receiverships generally commence with the debtor's assignment of its assets, vesting title to the assets in the assignee. Most states fall into one of three categories:

1. Those with a statutory ABC, such as Wisconsin and Florida
2. Those with a common law out-of-court system, such as Illinois
3. Those with no statutory ABC and no usage or recognition of the common law ABC

Statutory ABC. The Wisconsin statute, Chapter 128, is modeled on the U.S. Bankruptcy Act of 1898. To call the statute a procedural outline implies more substance than exists. The process is typically voluntarily commenced by a debtor assigning all of its assets to an assignee recommended by the debtor's lawyer and/or its secured lender. The number of people acting as assignees on a regular basis is relatively small, and generally the choice of a receiver is a relatively simple matter. Receivers should be disinterested because they act as a fiduciary for all creditors, secured and unsecured, as well as for shareholders.

A debtor can be forced into a receivership. A single creditor, or creditors, may apply to a court for appointment of a receiver if an execution against the debtor is returned unsatisfied, or a corporation is dissolved, insolvent, in imminent danger of insolvency, or has forfeited its corporate rights. The statute defines insolvent as follows: The aggregate of the person's property, exclusive of any property that the person may have conveyed, transferred, concealed or removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay the person's creditors, shall not, at a fair valuation, be sufficient in amount to pay the person's debts. Wisconsin Statutes, Chapter 128.001(1)(a).

The receivership court, at the receiver's request, issues an injunction against any other creditor proceedings against the debtor and its assets, a functional analog to the

Bankruptcy Code's automatic stay. The receiver must promptly give notice of the receivership, as well as the injunction and the claims bar date, to all creditors. The court supervises the proceedings and may issue any necessary orders and judgments. Functionally, a receivership operates with notice and an opportunity for hearing on major events, as in bankruptcy. The assignee is required to make an inventory of assets and list of creditors.

A secured creditor only participates at the creditor's sufferance because a security interest cannot be affected without the secured creditor's consent or by other valid legal proceeding. A secured creditor may become a party by general appearance or by filing a claim for a deficiency on a secured claim. Most secured creditors choose to participate. For many, a Chapter 128 receivership is their preferred remedy because of the cost savings and ability to maximize asset value.

The receiver operates the business and files a smaller number of first-day motions than is typical in bankruptcy cases. Those generally include requests for authority to continue operations until a going concern sale and retention of professionals, along with a financing motion and finance agreement with the debtor's bank. Given that the receiver needs to acknowledge perfection of the bank's security interest at the beginning of the case, those examinations must be done before the filing occurs. Receivership does not offer the luxury of the 20- to 30-day period in which the bank's security interest is temporarily recognized in a bankruptcy until creditors' committees and others can do a more thorough examination. This is not unlike any bankruptcy when debtor's counsel looks for any way to attack the bank's security interest prior to filing.

Most receivers, with court approval, hire a consultant to run the company during the receivership. Current management may remain as the receiver's employees, a role for which they may be compensated, provided they add value to the process. The receiver and debtor's attorney generally receive compensation during the case, although if the case is possibly administratively insolvent, receivers require the bank to guaranty payment of receivership expenses. As in a bankruptcy, the receiver may recover

preferential transfers. The “look-back” period is 120 days in Wisconsin and can be longer in other states.

A major reason lenders and purchasers of troubled companies use Chapter 128 is that the statute and case law expressly allow the receiver to “pass to the purchaser good title, free and clear of all liens.” The sale orders are similar to those issued in Bankruptcy Court and reassure the purchaser that it will not be burdened by the debtor’s past problems.

Common Law ABC. In Illinois, the regime is much different. In 1939, Illinois repealed its statutory ABC, and since that time, common law has controlled. It is an out-of-court process in which the debtor executes a trust agreement transferring its assets to the assignee. The assignee functions like the receiver in other jurisdictions, but it does so without court supervision and at the sufferance of creditors who at least tacitly must accept the process.

Illinois assignees are not protected by injunctions. Accordingly, creditors can still proceed to judgment against a debtor. Legally, however, such a judgment becomes a citation lien, which is subordinate to the assignee’s common law lien on the collateral. There are no provisions for preference actions, but receivers may bring fraudulent conveyance actions.

The assignment must be a written document. Legal title does not pass to the assignor, but is held in trust. The assignor cannot reserve any benefit from, or use of, the assigned assets. Failure to follow the formalities results in an invalid ABC, and creditors may garnish the funds in the hands of the pseudo-assignee.

The assignee has a duty to manage the assets with reasonable diligence. An assignee’s right to sell assets is implied, even if that is not expressed in the assignment. An assignee must make reasonable efforts to attain the highest price and sell the assets in the most favorable fashion. The assignee can turn to the courts for a declaratory judgment to resolve claims objections.

Federal Receiverships. While state receiverships are more common, receiverships are also available under federal law. Federal receiverships are most commonly requested by the U.S. Securities and Exchange Commission. When a receiver is appointed by the agency, it is operated for the benefit of the agency and not the trade creditors. Practitioners most often encounter these receiverships when their clients have invested in some form of Ponzi scheme.

Federal equity receiverships are also permitted and are generally brought by secured creditors, such as national banks. For these receiverships, since there is no general federal jurisdiction for creditors' rights, diversity and amount in controversy (\$75,000) must provide grounds for jurisdiction.

Bankruptcy as a Countermeasure

Although it is uncommon, a bankruptcy sometimes is filed after a receivership commences. A corporation or its creditors may not be precluded by state law from filing bankruptcy. A majority of courts hold that a timely commenced bankruptcy gives the Bankruptcy Court exclusive jurisdiction. The Bankruptcy Code can render an involuntary petition or property turnover ineffective if an assignment occurred less than 120 days before the bankruptcy petition. The Bankruptcy Court may abstain under Section 305 and often does.

The primary effects of a subsequent bankruptcy on a state receiver are found in Bankruptcy Code Section 543. Initially the receiver may not make disbursements for anything other than preserving estate property. The receiver must deliver and file an account with the court. The receiver is entitled to reasonable compensation but can be surcharged for improper or excess expenses.

An issue arose in California when a creditor challenged an assignee's attempt to recover a preference under the state ABC statute. The 9th U.S. Circuit Court of Appeals, in a 3-2 decision, held that California's ABC statute was preempted by the Bankruptcy Code.

Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198 (9th Cir.), cert. denied, 126 S. Ct. 397 (2005). Even in California, two state appellate courts have held that *Sherwood Partners* was wrongly decided. District courts elsewhere in the U.S. have generally concurred.

Legal Culture Impact on Choice

Receiverships have varying reputations around the country, depending on the legal culture and a particular law firm's familiarity with them. In some places, they are accepted at face value as an efficient and less costly bankruptcy alternative. In other places, they are viewed with suspicion as a method for clever debtors to somehow cheat their creditors.

Larger law firms generally are more comfortable with the extensive Bankruptcy Code and its case law. There is more certainty, and lawyers do not have to learn a different way of doing things. Also, since the costs of a receivership are substantially less than a bankruptcy, a firm finds that receivership is less lucrative for the professionals involved. These converging and conflicting values frequently lead lawyers away from recommending a receivership. But although the "certainty" of the bankruptcy process is a benefit, many times the associated costs may outweigh the perceived benefits.

Each case is different. Yet, given the relative risks, benefits, and associated costs, a state receivership or ABC many times may be in the best interest of creditors instead of a bankruptcy.



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