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The Role of a Receiver in a Bankruptcy Case

Thomas Rice – May 30, 2012

Litigants in both federal and state court have at their disposal a remedy to protect themselves from the dissipation of assets either during the course of litigation or following the entry of a judgment, which is the appointment of a receiver. When a bankruptcy case is filed that covers some or all of the assets that are subject to the receivership, a question can arise as to what role the receiver will play in connection with the bankruptcy case in an effort to undertake the receiver's fiduciary obligation to protect the assets that are part of the receivership.

The appointment of a receiver is an extraordinary equitable remedy that should only be applied with caution. *Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc.*, 999 F.2d 314, 316 (8th Cir. 1993). The focus in creating a receivership is to "safeguard the disputed assets, administer the property as suitable, and to assist the district court in achieving a final, equitable distribution of the assets if necessary." *Liberte Capital Group, LLC v. Capwill*, 462 F.3d 543, 551 (6th Cir. 2006). Under federal law, a receiver is appointed pursuant to Rule 66 of the Federal Rules of Civil Procedure. Upon appointment, a federal receiver is instructed by statute to manage the receivership property according to the law of the state where the property is located. 28 U.S.C. § 959(b). Thus, the acts undertaken by a receiver, whether appointed in a federal court case or state court case, are undertaken in accordance with applicable state law.

Authority to File for Bankruptcy Protection

Generally, the order appointing a receiver will grant broad powers to allow the receiver to obtain possession of the assets and maintain the operations of the entity placed under the control of the receiver. The receivership order may also specifically state that the receiver can liquidate the assets in a bankruptcy case, but such

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a requirement may not be necessary to authorize the filing of a bankruptcy case by the receiver.

The Bankruptcy Code does not set forth who has authority to file a voluntary petition on behalf of debtor; instead, courts look to state law to determine the issue of authority to file for bankruptcy protection. *Phillips v. First City, Texas-Tyler, N.A. (In re Phillips)*, 966 F.2d 926, 934 (5th Cir. 1992). Several courts have held that a receiver has the authority to file a bankruptcy petition on behalf of a corporation, limited-liability company, or limited partnership. *In re Statepark Building Group, LTD.*, 316 B.R. 466 (Bankr. N.D. Tex 2004); *Chitex Commun. Inc. v. Kramer*, 168 B.R. 587 (S.D. Tex. 1994). *See also In re Bayou Group*, 564 F.3d 541 (2nd Cir. 2009); *In re Petters Company, Inc.,* 401 B.R. 391 (Bankr. D. Minn. 2009).

There are courts, however, that have challenged the receiver's ability to file a voluntary petition. In the case of *In re Milestone Educational Inst., Inc.*, 167 B.R. 716 (Bankr. D. Mass. 1994), the receiver obtained a specific order from state court authorizing the receiver to file a Chapter 11 petition. The bankruptcy court questioned whether the state court could effectively grant such authority, as appointment of the receiver under state law did not deprive the corporate directors of the power to file a bankruptcy petition. *Id.* at 719–20. While the bankruptcy court ultimately decided to not dismiss the bankruptcy case, the court decided to abstain from going forward with the bankruptcy case while the creditor pursued an appeal of the state district court's decision authorizing the receiver to file a bankruptcy petition. *Id.*at 723–24.

In the case of *In re Monterey Equities-Hillside*, 73 B.R. 749 (Bankr. N.D. Cal. 1987), the bankruptcy court found that the receiver could not file a voluntary bankruptcy petition for a general partnership despite specific authority granted by state district court. *Id.*at 752. While the bankruptcy court denied the receiver's ability to file a voluntary petition for the debtor, the bankruptcy court held that under the terms of the receivership order, the receiver could file an involuntary petition against the entity. *Id.*

In contrast to allowing receivers to file voluntary petitions, some courts have maintained that the officers and directors of the corporation may still file a voluntary petition for the entity despite the entry of a receivership order. In the case of *In re Corporate and Leisure Event Productions, Inc.,* 351 B.R. 724 (Bankr. D. Ariz. 2006), the bankruptcy court considered a motion to dismiss filed by the receiver. In connection with the court's analysis, the bankruptcy judge noted that prior to enactment of the Bankruptcy Code, numerous courts had concluded that a state court receivership order could not bar an entity from filing for bankruptcy protection. *Id.*at 729–30 (citing *Struthers Furnace Co. v. Grant*, 30 F.2d 576 (6th Cir. 1929)). In denying the receiver's motion to dismiss, the bankruptcy court found that the officers and directors retained the ability to file a voluntary bankruptcy petition

for the corporate debtor. *Id.* at 732. A similar conclusion was reached in the case of *In re Orchards Village Investments, LLC*, 405 B.R. 341 (Bankr. D. Ore. 2009).

In contrast, some courts have held that appointment of the receiver deprived the shareholders from filing a voluntary petition. *See Chitex Commun., Inc. v. Kramer*, 168 B.R. 587 (S.D. Tex. 1994); *In re Statepark Building Group, Ltd.,* 316 B.R. 466 (Bankr. N.D. Tex. 2004); *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426 (Bankr. N.D. Ill. 1997). In the *Chitex* case, the state court had created a receivership to hold all the assets of the corporation during the pendency of the owners' divorce proceedings. *Chitex*, 168 B.R. at 588. Included within the state court receivership order was a provision that all the owners' stock interests in the corporation would be transferred to the receiver. *Id.* One of the spouses who was president of the debtor filed a voluntary petition for the debtor, asserting that while the receivership order divested ownership of the entity, the state court order did not remove him as an officer or director of the entity. *Id.* at 589–90. The bankruptcy court granted a motion to dismiss the bankruptcy case. *Id.* at 588. On appeal, the district court found that while the state court receivership order did not directly remove the spouse as an officer or director, the transfer of 100 percent ownership to the receiver constituted a de facto removal from any position of authority for the spouse. *Id.* at 589–90. In upholding the bankruptcy court's decision to dismiss the bankruptcy case, the federal district court held that all of the rights to control the corporation, including the ability to file a voluntary bankruptcy petition, had been transferred to the receiver. *Id.*at 590.

Authority to Act on Behalf of the Debtor-In-Possession

When an entity files a voluntary petition under Chapter 11, Section 1107 of the Bankruptcy Code authorizes the prepetition management to continue operating the business as a debtor-in-possession on behalf of all creditors, equity holders, and other parties in interest. In contrast, when a receiver has been appointed prepetition to control the debtor's operations, such appointment is made by either a federal court or state court in connection with a particular lawsuit pending before such court, which typically does not involve all of the corporate debtor's creditors. In fact, the receiver is an agent of the court that makes the appointment. *Resolution Trust Corp. v. Volpe*, 912 F. Supp. 65, 69 (W.D.N.Y. 1996). Additionally, the court undertaking the litigation may propose that the liquidation of the assets be undertaken in a manner inconsistent with the Bankruptcy Code. *S.E.C. v. TLC Inv. and Trade Co.*, 147 F. Supp. 2d 1031 (C.D. Cal. 2001). Therefore, a question arises whether the receiver can continue to act as the debtor-in-possession after the filing of a voluntary petition.

At least one court of appeals has affirmed a lower court's decision to retain a receiver to act as the decision maker for the debtor-in-

possession. *See In re Bayou Group*, *LLC*, 564 F.3d 541 (2nd Cir. 2009). In a district court opinion that was affirmed by the Court of Appeals, the district court judge examined under what authority the receiver could continue to act on behalf of the debtor-in-possession. *In re Bayou Group, LLC*, 363 B.R. 674 (S.D.N.Y. 2007). Prepetition, the debtor had been operated as a ponzi scheme. After the federal government disrupted the debtor's operations, a group of creditors formed an unofficial committee to undertake a concerted effort to pursue litigation claims. The unofficial committee sought the appointment of a receiver to pursue such claims. Ultimately, the district court appointed the receiver as both receiver and managing member of the debtor. The receiver decided to file a voluntary petition. Following the filing of the bankruptcy petition, the United States Trustee (UST) filed a motion to appoint a Chapter 11 trustee for the debtor. The UST asserted that upon filing of the bankruptcy case, the receiver became a custodian of the debtor's assets under § 543 and his role as receiver terminated. The UST asserted that as a custodian, the receiver could not continue to manage the debtor-in-possession. The bankruptcy court disagreed and denied the UST's motion to appoint a Chapter 11 trustee. *Id.* at 682.

The district court began its analysis by examining the terms of the receivership order, which appointed the receiver as both a "non-bankruptcy federal equity receiver and exclusive managing member" of the debtor. *Id.*at 683–86. Initially, the district court noted that the receiver could have been appointed to manage the debtor under the federal receivership statutes alone. *Id.*at 683–84. The district court agreed that if the receiver had been appointed in such a manner, then Section 543 would apply and the receiver's ability to manage the debtor would have terminated on the petition date. *Id.*at 684. The receivership order, however, went beyond simply appointing the receiver to manage the debtor under the receivership statutes; instead, the receiver had been appointed the managing member of the debtor, which was separate and apart from his role as receiver. *Id.*at 684–86. Therefore, the district court determined that the receiver could continue to undertake management of the debtor-in-possession. *Id.* at 687.

At least two other courts have considered whether a receiver can continue to act on behalf of the debtor-in-possession. In the case of *In re Petters Company, Inc.*, 401 B.R. 391 (Bankr. D. Minn. 2009), the bankruptcy court recognized that there was a dearth of case law regarding whether the receiver could continue to manage the affairs of the debtor-in-possession. *Id.*at 401. The bankruptcy court avoided the issue by appointing the receiver as Chapter 11 trustee for the debtor. *Id.*at 414. In another similar case, the bankruptcy court, without a detailed explanation, authorized the receiver to continue acting on behalf of the debtor-in-possession. *In re J.B. Flex, Inc.*, Case No. 12–10526, 2012 Bankr. LEXIS 616 (Bankr. S.D. Ohio Feb. 17, 2012).

While there is no specific authority denying that a receiver can continue managing the operations of the debtor-in-possession, the authority supporting the receiver's continuing ability to manage the debtor-in-possession in such a role is very limited. The bankruptcy court's decision in *In re Petters* to appoint the receiver as the Chapter 11 trustee may ultimately be a decision that satisfies the parameters of the Bankruptcy Code while recognizing the decision to appoint a receiver in the first place.

The Receiver as a Custodian of the Debtor's Property

In the event a receiver does not continue to manage the operations of the debtor-in-possession or is not appointed a Chapter 11 trustee, then under Section 101(11)(A) of the Bankruptcy Code the receiver is a custodian over the assets that are part of the receivership. Under Section 543 of the Bankruptcy Code, the receiver as custodian is obligated to take only such actions that will preserve the debtor's property until the property can be delivered to either the debtor-in-possession or the Chapter 11 trustee. The receiver will also be required to file an accounting of any property that came into his or her possession during the course of the receivership. 11 U.S.C. § 543(b)(2).

In connection with the receiver turning over the assets in the receiver's custody to the estate, the receiver is entitled to seek allowance of the actual, necessary expenses incurred by the receiver as well as compensation for the services provided by the receiver. 11 U.S.C. § 503(b)(3)(E). The amounts awarded as an administrative expense claim can include both prepetition and postpetition services provided by the receiver. *In re Snergy Properties, Inc.*, 130 B.R. 700, 704 (Bankr. S.D.N.Y. 1991). To be entitled to an administrative expense claim under Section 503(b)(3)(E), the receiver must demonstrate that the actions undertaken under the receivership were for the benefit of the estate. *In re Bodenheimer, Jones, Szwak, & Winchell LLP*, 592 F.3d 664, 672 (5th Cir. 2009); *In re R&G Properties, Inc.*, Case No. 08–10876, Bankr.LEXIS 1318, *8 (Bankr. D. Vt. April 30, 2009). The court can also award as an administrative expense claim, the fees and expenses incurred by counsel retained by the receiver in undertaking his duties under Section 503(b)(4). *In re Snergy*, 130 B.R. at 704–5; *In re China Village, LLC*, Case No. 10–60373, 2012 Bankr. LEXIS 105 (Bankr. N.D. Cal. Jan. 5, 2012).

In conclusion, while the filing of a bankruptcy case will typically mean that a receiver appointed in either federal court or state court litigation is simply required to turnover the assets to representatives of the estate, it is not a foregone conclusion that the receiver must simply step aside. The receiver may play a pivotal role in either the decision-making process for filing a bankruptcy case or end up continuing to manage the debtor's affairs. At a minimum, the receiver may affect the cost of administering a bankruptcy case to the extent that the receiver's

fees and expenses are determined to be beneficial to the bankruptcy estate and allowed by the bankruptcy court as an administrative expense of the estate.

Keywords: bankruptcy, litigation, receiver, voluntary petition, debtor-in-possession, custodian, 11 U.S.C. § 543, 11 U.S.C. § 503

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