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# *Intersection of Receiverships and Bankruptcy*

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# Intersection of Receiverships and Bankruptcy

by J. Michael Levengood[1]

This paper is written for attorneys representing stakeholders of commercial borrowers in financial distress in Georgia (including secured creditors, unsecured creditors, and borrowers) and compares and contrasts receiverships in state and federal courts with bankruptcy administration as competing procedures designed to facilitate the liquidation or reorganization of companies in financial distress. Shortly after Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, there were many predictions that companies in financial distress would resort to state or federal court receiverships to liquidate or reorganize rather than bankruptcy. This prediction has not materialized at least for businesses in financial distress with complex debt and capital structures. One reason may be that prospective buyers of assets from sellers in financial distress have more experience with Bankruptcy Court and are more comfortable about their ability to obtain marketable title free and clear of liens, claims and encumbrances when the property is purchased from the seller in a bankruptcy case pursuant to a final order. Perhaps the absence in receiverships of clear rules such as the Bankruptcy Code's rules regarding assumption, assignment and rejection of executory contracts is a factor. For secured creditors the appeal of a receivership is that it is likely to be less expensive than a chapter 11 bankruptcy case. However, when a receivership is superseded by a bankruptcy case, the potential cost savings evaporate and the result is likely to be greater cost than if the parties had

[1] The author thanks S. Elizabeth Hall and Matthew Weiss, Associates at McKenna Long & Aldridge LLP, for their assistance in the preparation of this paper.

resorted to bankruptcy in the first place. Nevertheless, receiverships continue to play an important role in the liquidation and restructuring of companies in financial distress. This paper examines the reasons why.

## Introduction

As mentioned above, one practical limitation of receiverships is the possibility that after a receivership case commences, the debtor may react by filing a voluntary petition for relief under the Bankruptcy Code or three unsecured creditors may join together to file an involuntary petition to displace the receivership. An example of this limitation and of the intersection of receiverships and bankruptcy is Ply-Marts, Inc., which was a commercial borrower and a building supply company in the southeastern United States that encountered financial distress as a result of the economic recession and the 2008 collapse of the residential real estate construction industry in Georgia. The author represented the federal receiver for Ply-Marts, Inc. before and during the involuntary Chapter 11 case commenced by three unsecured creditors shortly after the receiver was appointed by the U.S. District Court for the Northern District of Georgia at the request of the secured creditor and with the consent of Ply-Marts, Inc. Judge Diehl is the bankruptcy judge in the Ply-Marts, Inc. bankruptcy case, Chapter 7 Case No. 08-72687-mgd**,** which is now in liquidation under Chapter 7 of the Bankruptcy Code. Judge Diehl entered several consent orders in the involuntary bankruptcy case that postponed the turnover of assets by the receiver, authorized the secured creditor to extend credit to the receiver following the filing of the involuntary petition for relief and permitted the receiver to sell the Ply-Mart operating divisions as going concerns and to wind down the business in an orderly fashion. Judge Diehl also ultimately entered an order for relief, denied the joint motion of the secured creditor and the receiver for relief

under Bankruptcy Code sections 305 (seeking abstention and/or dismissal) and 543 (seeking to excuse the receiver as custodian from compliance with the bankruptcy turnover requirements of that section), granted the secured creditor's motion for relief from stay and granted the secured creditor's motion to convert the Chapter 11 case to a Chapter 7 case. The receiver then promptly turned over the remaining property in the receivership estate to the trustee and filed his final accounting. The Chapter 7 trustee in the Ply-Marts, Inc. case subsequently has filed approximately 40 preference avoidance and recovery actions, something the receiver did not have the power to do. Therefore, the Ply-Marts, Inc. case is a local and relatively typical example of the intersection of receiverships and bankruptcy.

When unsecured creditors consider whether they would be better off in a bankruptcy case than in a receivership, they are commonly concerned about a lack of information, the perceived excessive control by the secured creditor who sought the appointment of a receiver and the lack of notice and other rules and procedures in a receivership that are commonly found in a bankruptcy case, where rules and procedures are designed to facilitate the orderly liquidation of companies in financial distress in an open and transparent fashion. On the other hand, many companies in distress cannot afford the overhead of a bankruptcy case and receiverships can be a less expensive alternative. When work out negotiations have run their course without a successful outcome and the secured creditor is unwilling to provide debtor in possession financing in bankruptcy, the borrower's board of directors and unsecured creditors may become satisfied that the receivership will afford a greater opportunity for a distribution than might occur in a bankruptcy case. What happens at the intersection of receiverships and bankruptcy varies depending on the types of receiverships, the amount and type of

debt, the existence of claims that might be pursued more effectively by receivers than a trustee in bankruptcy and the existence of claims that may only be pursued in bankruptcy cases.

## I. Types of Receiverships

Although the U.S. Constitution grants to Congress the power to establish uniform laws on the subject of bankruptcy for much of the 19th century Congress did not do so. During the century leading up to the passage of the Bankruptcy Act of 1898, Congress reacted to economic crises by passing bankruptcy laws that only lasted for a few years.[2] Consequently, the liquidation of companies in distress was ordinarily the province of the state debtor and creditor laws, and states whose courts exercised powers of equity to appoint receivers to provide for court supervision of the process. Receivers are officers of the courts that appoint them and their powers are specified in the orders that appoint them. Consideration of every receivership should start with a review of that order.

### A. Federal Equity Receiverships

#### 1. Railroad Receiverships

As railroad companies were established and expanded during the Nineteenth Century in America, many small railroads were placed into equity receiverships when they encountered financial distress. In appropriate cases, customarily railroad companies that owned assets in more than one state, creditors turned to the federal courts because of their ability to administer receiverships of such companies across state lines. Many of the rules created by the federal courts in these federal equity

[2] Congress enacted three bankruptcy laws before passage of the Bankruptcy Act of 1898. The first bankruptcy law was enacted in 1800 and was limited to involuntary bankruptcy of traders. It was repealed in 1803. The second bankruptcy law was enacted in 1841 and allowed both voluntary and involuntary bankruptcy. It was repealed in 1843. The third bankruptcy law was enacted in 1867, amended in 1874 to permit compositions, and repealed in 1878.

receiverships were incorporated into the reorganization provisions of the Bankruptcy Act of 1898. Interestingly, railroad reorganizations remained the province of equity receiverships until 1933 when Congress enacted section 77 of the Bankruptcy Act to govern railroad reorganizations. Whether liquidation of railroads was possible under section 77 of the Bankruptcy Act was not clear. With the passage of the Bankruptcy Reform Act of 1978, and the adoption of sections 1161 through 1173 of the Bankruptcy Code, Congress revised many of the provisions of section 77 of the Bankruptcy Act in order to facilitate the reorganization of railroads. Although Bankruptcy Code Section 109(b)(1) provides that a railroad may not be debtor in a Chapter 7 case, Bankruptcy Code section 1174 clarifies the law by providing that bankruptcy courts may terminate a railroad's operations and liquidate the estate under certain circumstances. See Norton Bankruptcy Law and Practice 3d, § 117:18.

In an article entitled, Railroad Receivership and the Origins of Corporate Reorganization, University of Mary Washington Economics Professor Bradley Hansen states:

> The 1898 Bankruptcy Act was designed to aid creditors in liquidation of an insolvent debtor's assets, but one of the important features of current bankruptcy law is the provision for reorganization of insolvent corporations. To find the origins of corporate reorganization one has to look outside the early evolution of bankruptcy law and look instead at the evolution of receiverships for insolvent railroads. A receiver is an individual appointed by a court to take control of some property, but courts in the nineteenth century developed this tool as a means to reorganize troubled railroads. **The first reorganization through receivership occurred in 1846, when a Georgia court appointed a receiver over the insolvent Munroe [sic] Railway Co. and successfully reorganized it as the Macon and Western Railway.** In the last two decades of the nineteenth century the number of receiverships increased dramatically; [Table 3 omitted]. In theory, courts were supposed to appoint an indifferent party as receiver, and the receiver was merely to conserve the railroad while the best means to liquidate it was ascertained. In fact, judges routinely appointed the president, vice-

> president or other officers of the insolvent railway and assigned them the task of getting the railroad back on its feet. The object of the receivership was typically a sale of the railroad as a whole. But the sale was at least partly a fiction. The sole bidder was usually a committee of the bondholders using their bonds as payment. Thus the receivership involved a financial reorganization of the firm in which the bond and stock holders of the railroad traded in their old securities for new ones. The task of the reorganizers was to find a plan acceptable to the bondholders. For example, in the Wabash receivership of 1886, first mortgage bondholders ultimately agreed to exchange their 7 percent bonds for new ones of 5 percent. The sale resulted in the creation of a new railroad with the assets of the old. Often the transformation was simply a matter of changing "Railway" to "Railroad" in the name of the corporation. Throughout the late nineteenth and early twentieth centuries judges denied other corporations the right to reorganize through receivership. They emphasized that railroads were special because of their importance to the public.
>
> Unlike the credit supplied by merchants and manufacturers, much of the debt of railroads was secured. For example, bondholders might have a mortgage that said they could claim a specific line of track if the railroad failed to make its bond payments. If a railroad became insolvent different groups of bondholders might claim different parts of the railroad. Such piecemeal liquidation of a business presented two problems in the case of railroads. First, many people believed that piecemeal liquidation would destroy much of the value of the assets. In his 1859 Treatise on the Law of Railways, Isaac Redfield explained that, "The railway, like a complicated machine, consists of a great number of parts, the combined action of which is necessary to produce revenue." Second, railroads were regarded as quasi-public corporations. They were given subsidies and special privileges. Their charters often stated that their corporate status had been granted in exchange for service to the public. Courts were reluctant to treat railroads like other enterprises when they became insolvent and instead used receivership proceedings to make sure that the railroad continued to operate while its finances were reorganized.

Emphasis added. Hansen, Bradley. "Bankruptcy Law in the United States". EH.Net Encyclopedia, edited by Robert Whaples. August 14, 2001. URL http://eh.net/encyclopedia/article/hansen.bankruptcy.law.us.

Justice Lumpkin writing for the Supreme Court of Georgia in a subsequent case involving the successor to the Monroe Railroad Company assets and a claimant to the sale proceeds arising from its purchase of the assets, discussed the “receivership” as follows:

In 1833, the Legislature granted a charter to the Monroe Railroad Company, to construct a railroad from Macon to Forsyth. In 1835, an Act was passed amending and reviving the Act of 1833, and in 1836, another Act was passed, amending and extending the provisions of the original charter. This last Act provides, that the company may increase their stock so as to extend their road in a northwestern direction, and also confers banking privileges.

On the 2d of August, 1842, said company being greatly embarrassed and unable to proceed with their work, which was in a very imperfect and ruinous condition, even below Forsyth, entered into a contract with Robert Collins, Elam Alexander, John D. Gray & Co. Daniel McDougald and Arthur B. Davis, to build and equip the said road from and between Griffin and Atlanta; and, among other things, it was stipulated, that the entire railroad with all its appurtenances, should be vested in the said contractors, until all the dues, and payments to which they should be entitled under said contract should be fully met and satisfied.

In 1844, the Roswell Manufacturing Company and other creditors, having obtained judgments against the Monroe Railroad and Banking Company, sought to subject said road to levy and sale, at law, by virtue of their executions.

...

David C. Campbell, Abner P. Powers, James A. Nisbet, Samuel B. Hunter and Thomas Hardeman, were appointed commissioners to sell the road, on the first Tuesday in August, 1845, after giving two months' notice in the public gazettes of Macon, Griffin and Savannah, and the proceeds were directed to be paid into Court-public notice was to be given to the creditors of the company to file their claims or a schedule of them with the Clerk, by the first Monday in October next ensuing the sale; and in the event of any controversy, the creditors were authorized and directed to litigate among themselves, and their several and respective liens were to be investigated and adjudicated.

It was further decreed, that the purchasers of the road should succeed to all the obligations of the company in regard to the completing, equipping and keeping the road in operation, as intended and designed by the Act of incorporation, but not to extend to any liability for debts contracted prior to the sale; and, *finally*, William B. Parker, the complainant in the bill, was appointed *trustee* in charge of the road, with its appurtenances, until the sale should be consummated; and it was made his duty to make monthly returns of the receipts and expenditures, and file the same with the Clerk of the Court, subject to the examination and approval of the Court.

In pursuance of this decree, the road was sold at the time and place designated, and bid off by Jerry Cowles, acting as the agent of Daniel

> Tyler, at and for the sum of $155,000, and a deed was executed by the commissioners. The whole amount brought into Court for distribution, including the price of some disconnected property, was $160,525.33.
>
> To settle the difficulty as to the sale of a franchise, without the consent of the power which granted it, upon application to the Legislature, an Act was passed in 1847, creating Daniel Tyler, the purchaser, and his associates, a body politic and corporate, by the name and style of the Macon & Western Railroad Company, and conferring on them all the powers, privileges and immunities of the old company, with the exception of banking. *Pamphlet Laws of* 1847, *p*. 181.

Macon & W.R. Co. v. Parker, 9 Ga. 377, 1851 WL 1441.

Accordingly, it appears that Georgia's place in history as the first railroad reorganization through receivership stands on somewhat shaky ground. Although according to Justice Lumpkin's recitation of the facts, the Georgia court used its powers of equity to direct the sale of the railroad and subsequent distribution of sale proceeds to creditors, alas, the receivers (the court appointed officers) bore the title of commissioner or trustee rather than Receiver, and in many ways their charge resembled more the Bankruptcy Code section 363 sale of assets followed by the distribution of sale proceeds to interested parties in order of priority than a true reorganization.

2. SEC and CFTC Receiverships

In furtherance of the policies underlying the establishment of the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"), the SEC and the CFTC commonly resort to the equitable power of the federal courts to place in receivership businesses where there is evidence of securities fraud. District courts act with broad discretion when fashioning relief in cases involving equity receiverships, including receiverships initiated in such enforcement actions. Ultimately, district courts have "the power to fashion any distribution plan that is fair and equitable" SEC v. Sunwest Mgmt., Inc., No. 09-6056-HO, 2009 WL 3245879, *8

(D. Or. Oct. 2, 2009) and their "power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad." SEC v. Capitol Consultants, LLC, 397 F.3d 733, 738 (9th Cir. 2004) (quoting SEC v. Hardy, 803 F.2d 1034, 1037 (9th Cir. 1986)). Consequently, the district court is charged with utilizing its "broad powers" and "wide discretion," SEC v. Elliot, 953 F.2d 1560, 1569-70 (11th Cir. 1992) to "determine the most equitable distribution result for *all* claimants" of the receivership. Sunwest Mgmt., Inc., 2009 WL 3245879 at *9 (emphasis added). Finally, because case law involving district courts' administration of receivership estates is sparse, court determinations are "usually limited to the facts of the particular case." Capitol Consultants, LLC, 397 F.3d at 750. Because the focus of a receiver in an SEC or CFTC receivership is customarily broader than that of a receiver in a case commenced by a secured creditor of a commercial borrower in financial distress, the outcome in subsequent bankruptcy cases is that SEC or CFTC receivers may be more likely to remain in control of the bankrupt entities than a receiver appointed at the behest of a secured creditor.

3. Other Multi-State Corporate Receiverships

With the rise of companies owning real and personal property in more than one state, where diversity of citizenship between the secured creditor and the borrower is present, federal receiverships offer the same type of benefits found in the railroad receiverships. One court can supervise the multi-state liquidation or reorganization, thereby reducing the cost of the process. The Ply-Marts, Inc. case is an example of such a federal equity receivership. It was commenced in federal rather than state court because the debtor had operating assets in more than one state and there was diversity

of citizenship between the secured creditor plaintiff and commercial borrower defendant.

### B. **State Equity Receiverships**

#### 1. Insurance Companies, Banks and Other Entities Not Eligible for Bankruptcy

Bankruptcy does not intersect with receiverships where the business entity that is in distress is not eligible to be a debtor in a bankruptcy case. Bankruptcy is unavailable to such institutions and their liquidation is customarily supervised under state or federal receiverships. Section 109 (b) of the Bankruptcy Code provides:

> A person may be a debtor under chapter 7 of this title only if such person is not --
>
> (1) a railroad:
>
> (2) a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, a New Market Venture Capital company as defined in section 351 of the Small Business Investment Act of 1958, a small business investment company licensed by the Small Business Administration under section 301 of the Small Business Investment Act of 1958, credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act, except that an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as , a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor if a petition is filed at the direction of the Board of Governors of the Federal Reserve System; or
>
> (3) (A) a foreign insurance company engaged in such business in the United States; or
>
> (B) a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union, that has a branch or agency (as defined in section 1(b) of the International Banking Act of 1978 in the United States.

Section 109(d) of the Bankruptcy Code provides that only a railroad or a person that may be a debtor under Chapter 7 of the Bankruptcy Code, and an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act with certain qualifications may be a debtor under Chapter 11 of the Bankruptcy Code.

2. Real Estate in Distress Receivership Commenced by Secured Creditor

Georgia law on state court equity receiverships may be found at O.C.G.A. § 9-8-1 et seq. The most common state court receivership is the real estate receivership commenced by the secured creditor that holds the mortgage on the property and has the right under its security deed to have a receiver appointed upon an event of default by the borrower. These types of receiverships commonly intersect with bankruptcy either because the borrower files a voluntary petition for relief under the Bankruptcy Code or because creditors of the borrower commence an involuntary bankruptcy case. The general rule under section 543 of the Bankruptcy Code is that a receiver as custodian is directed to turn over to the trustee or debtor in possession the assets in the receiver's possession upon receipt of notice of the commencement of the bankruptcy case and to file an accounting with the bankruptcy court. Depending on the amount of time that the receivership has been pending and other factors regarding the prepetition management of the assets, a receiver may be excused from turning over the property to the debtor. See Section VII.

3. Operating Company in Distress Receivership Commenced by Secured Creditor

Georgia law permits receiverships for commercial borrowers in distress or in cases of corporate deadlock as well as many other instances when any fund or property is in litigation and the rights of either or both parties cannot otherwise be fully protected

or when there is a fund or property having no one to manage it. See Macon & W.R. Co. v. Parker, 9 Ga. 377 (1851) (authorizing "receiver" to liquidate receivership estate and arrange for payment of its creditors); see also Jerome L. Kaplan, Kaplan's Nadler Georgia Corporations, Limited Partnerships and Limited Liability Companies, § 12.1 (2010-11 ed.)(generally discussing availability of equity receiverships for corporate reorganization in Georgia). It is not surprising to see a state court equity receivership of an operating company where the secured creditor desires to have a court-supervised process and the borrower's board of directors or managers and its equity acknowledge that a receivership is appropriate because they have concluded that the business cannot continue and that a going concern business sale would provide a greater return than a forced liquidation of the company's inventory and equipment. Receivers are not forced to liquidate the company's assets in a state court receivership but may, with appropriate language in the receivership order, continue to operate the business. However, because of limitations applicable to states regarding interference with contract rights and the discharge of claims, in the absence of full payment of creditors or unanimous creditor consent to acceptance of less than payment in full, it would seem that a more likely outcome of such "operating" receiverships is a court-supervised sale of the business as a going concern followed by a distribution of the sale proceeds to creditors rather than a true reorganization. Where the goal of the proceeding is to sell all or a portion of a business as a going concern, a purchaser is going to require that it obtain clear title. Even if the law may allow a receiver to sell "free and clear" if there is not clear law from the highest court in the jurisdiction, a more robust sale could take place in bankruptcy where the law is more settled.

## II. **Benefits of Receiverships**

### A. **In Pari Delicto**

The in pari delicto doctrine is an equitable defense similar to the doctrine of unclean hands in which a plaintiff that participated in allegedly wrongful conduct is estopped from recovering damages from a fellow wrongdoer. As noted in Official Comm. of Unsecured Creditors of Alleghany Health, Educ. and Research Found. v. PricewaterhouseCoopers, LLP, 2008 WL 3895559 (July 1, 2008), "[i]n pari delicto is a murky area of law. It is an ill-defined group of doctrines that prevents courts from becoming involved in disputes in which the adverse parties are equally at fault." Id. at *5. The application of the doctrine has been just as murky when a third party is placed in control of the entity. Although early use of this defense against trustees in bankruptcy or creditor committees seemed to gain traction, courts have been less likely to apply it when the plaintiff was the receiver appointed by the court for the receivership estate.

In the case of Hays v. Paul, Hastings, Janofsky & Walker LLP, No. 1:06-CV-754-CAP, slip op. at 25-27 (N.D.Ga. Sept. 14, 2006), the court applied Georgia law and declined to apply the in pari delicto doctrine to bar a receiver's claims. Similarly, the Seventh Circuit has found that the in pari delicto doctrine is inapplicable to a receiver. Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) (holding that "the defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated."). Further, although the Third Circuit extended the application of the doctrine of in pari delicto to bar the claims of an unsecured creditors committee in Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001), the court went on to distinguish receivership proceedings from bankruptcy cases, because "unlike

bankruptcy trustees, receivers are not subject to § 541." Id. at 358. The Fifth Circuit, however, applied the defense in the case of FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992), and precluded the receiver from asserting claims under the in pari delicto doctrine.

In a recent order in an adversary complaint filed in conjunction with the International Management Associates, LLC ("IMA") bankruptcy, the District Court for the Northern District of Georgia denied summary judgment regarding the in pari delicto defense against the bankruptcy trustee. Perkins v. Smith, Gambrell & Russell, LLP, et. al., No. 1:08-CV-2673-JEC, slip op. at 35-39 (N.D. Ga. July 27, 2010) (motion for reconsideration pending). The court relied on Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1151 (11th Cir. 2006), for the proposition that the doctrine may be asserted against a bankruptcy trustee. The court goes on to assert that based on Edwards, the doctrine may be applicable against a trustee *or a receiver*, stating that it "rejects the plaintiff's argument that the in pari delicto doctrine cannot apply because the wrongdoer has been removed and plaintiff, either as receiver or as bankruptcy trustee is 'an innocent party.'" Id. at 36. However, the court noted that there were disputed issues of fact regarding whether the wrongdoing by the corporate officer could be imputed to the prepetition debtor, because there is an adverse interest exception to the imputation of knowledge when the officer departs from the scope of his duties. Id. at 37.

In an interesting twist, a federal district court has held that the appointment of a receiver before the commencement of a bankruptcy case effectively cleanses the debtor thereby insulating a liquidating trustee of the debtor from the taint of the former bad actors so that the in pari delicto doctrine does not bar the trustee from asserting his

claims. In the case of In re Le-Nature's Inc., 2009 WL 3571331 (W.D.Pa.), the district court distinguished the Third Circuit's Lafferty decision, stating:

> In Lafferty, two debtor corporations filed for bankruptcy after a "Ponzi scheme" collapsed leaving the investors in these corporations with substantial losses. The scheme was orchestrated by the corporate debtors' sole shareholder, William Shapiro, who issued fraudulent debt certificates on behalf of the corporations. When the corporations had no prospect of repaying the debt, the corporations sought protection through bankruptcy. Subsequent to the bankruptcy filings, the debtors' estates, through their creditors' committees, brought claims alleging that third parties had fraudulently induced the debtor corporations to issue debt securities thereby deepening their insolvency and forcing them into bankruptcy.
>
> One of the main issues in the Lafferty case was whether the in pari delicto doctrine would bar the claims brought by the creditor's committee on behalf of the debtors' estates. The Court of Appeals for the Third Circuit held that in pari delicto could bar the claims if Shapiro's conduct could be imputed to the corporations and hence to the creditors' committees since the committees stood in the shoes of the debtor-corporations.
>
> ...
>
> Unlike the facts in Lafferty, I must evaluate the in pari delicto doctrine in light of the fact that when Kirschner stepped into the shoes of Le-Nature's it was no longer being operated by a corrupt management team (Podlucky and the Insiders) due to the minority shareholders who convinced the Chancery Court to replace the leadership. Thus, at the moment the bankruptcy was filed, Le-Nature's was not being run by the wrongdoers who allegedly engaged in fraud. FN11 This distinction alone leads me to conclude that since Le-Nature's alleged wrongdoing shareholders were stripped of their power by the alleged innocent minority shareholders prior to the bankruptcy filing, there was nothing to impute at the time of the bankruptcy filing, and accordingly, the in pari delicto doctrine cannot apply to bar Kirschner's claims against Krones. FN12
>
> FN11. I find Judge Cowen's dissent in Lafferty instructive on this point. He notes that the Lafferty majority concluded that the creditors' committees were barred from recovery because "at the moment the bankruptcy was filed the wrongdoers had not actually been removed yet." 267 F.3d at 362. In Lafferty, the trustee took over a company which, until the moment the trustee assumed control, had been run by a corrupt shareholder. This directly contrasts with the facts of the immediate case. Although Krones suggests that the brief period of the time the custodian actually controlled Le-Nature's prior to the bankruptcy filing was not enough to "cleanse" the

company of the "taint," I disagree based on the majority and dissenting opinions in Lafferty.

FN12. Even assuming, arguendo, that the minority shareholder's actions, KCZ's succession, and KCZ's control over Le-Nature's (all of which predated the filing of the bankruptcy) are of no moment, the second part of the Lafferty analysis-where the Court questions whether the acts and conduct of Podlucky and the Insiders can be imputed to Le-Nature's-also fails.

As indicated above, although the case law in this area is still developing, early indications have been that courts are more likely to apply the in pari delicto defense to preclude claims by trustees, debtors in possession and unsecured creditors committees than receivers.

B. **Unitary Enterprise Theory**

Receiverships are also favored over bankruptcy proceedings because of the ease through which a Receiver can consolidate the assets of various receivership entities into a single fund to treat all entities within the receivership estate as a "unitary enterprise". At the federal level, district courts act with "wide discretion" in using their "broad powers" to establish a unitary enterprise. SEC v. Sunwest Mgmt., Inc., No. 09-6056-HO, 2009 WL 3245879, *8 (D. Or. Oct. 2, 2009).

When a district court determines that various entities under the control of a receivership estate acted as a unitary enterprise in the course of perpetuating a fraudulent scheme, the critical element is a finding that the persons responsible for the fraudulent activity "did not respect the separateness of the Receivership Entities nor the restricted purposes of invested funds that were intended to be limited to use for specific facilities." SEC v. Sunwest Mgmt., Inc., 2009 WL 3245879 at *1. In those circumstances, courts determine that the receivership entities have become part of a

"unified scheme to defraud" the various investors and creditors of the receivership estate. SEC v. Byers, 637 F. Supp. 2d 166, 181 (S.D.N.Y. 2009).

The essential element of any unitary enterprise is the commingling of funds, such that fraudulently obtained funds have been mixed with the legitimately held assets of the receivership entities. Commingling of funds can take different forms. Court have consolidated assets due to commingling where parties combined the funds from various receivership entities with operational revenue into a single centralized fund, out of which all operating expenses and distributions for each receivership entity were paid. See Sunwest Mgmt., Inc., 2009 WL 3245879 at *4 (SEC alleged that defendants "commingl[ed] investor and creditor funds and operational revenue into essentially a single fund" which was then funneled into one of the defendant's personal bank accounts and was then redistributed as operating expenses and investor returns); Byers, 637 F. Supp. 2d at 180 (finding unitary enterprise where "cash from the operations was routinely pooled to pay for operating expenses and distributions across various offerings"). Commingling has also been found where money was moved indiscriminately between corporate entities without regard for any corporate formalities. Byers, 637 F. Supp. 2d at 178.

Federal district courts have embraced a lenient standard for finding that funds within a corporate account have been commingled, stating that any evidence that illegally obtained funds have been placed into an account taints all funds within that account. Sunwest Mgmt., Inc., 2009 WL 3245879 at *9. Rather than finding that the commingling of funds must be systematic such that it would be impossible to trace the funds from individual creditors or investors, as is frequently the standard for the similar remedy of substantive consolidation in bankruptcy cases, district courts have found the

existence of unitary enterprises due to commingling where there is any evidence that the defendants have "blurr[ed] the distinction between the Receivership Funds." CFTC v. Eustace, No. 05-2973, 2008 WL 471574, *7 (E.D. Pa. Feb. 19, 2008). Thus, the government only has the burden of proving that some tainted proceeds have been commingled with other funds. Byers, 637 F. Supp. 2d at 178.

Once a determination has been made that receivership entities have functioned as a unitary enterprise, courts create a constructive trust over all assets of the receivership estate and each investor and creditor has an equitable interest in all of the funds within that trust. SEC v. The Better Life Club of Am., Inc., 995 F. Supp. 167, 181 (D.D.C. 1998). The, the assets within the trust are distributed on a pro rata basis. Under a pro rata distribution, the claims of creditors and investors of all receivership entities are satisfied at an equal proportion out of the consolidated res of the receivership estate. The use of this type of distribution is "most favored" in receivership cases. Byers, 737 F. Supp. 2d at 176-77.

It is because of the relative ease with which a Receiver may resort to a unitary enterprise theory that general creditors of the receivership estate (including defrauded securities investors) stand to gain the most from a receivership distribution, because they are able to participate in a pro rata distribution of the combined receivership estate assets. Conversely, creditors who dealt solely with a single entity within the receivership estate and who, under traditional bankruptcy substantive consolidation principles could resist the pooling of the assets and liabilities of that entity with the larger receivership estate, might be able to receive a greater distribution under a bankruptcy of their single entity than under a receivership unitary enterprise and so would likely prefer to place the entity against which they hold claims in bankruptcy.

## III. **Disadvantages of Receiverships**

### A. **No Discharge / Limited Opportunities for Reorganization**

State courts may not provide a discharge of liability for creditor claims and so unless all creditors agree to accept less than full payment of their debts, reorganization of the business is unlikely. As the U. S. Supreme Court held in the case of International Shoe v. Pinkus, 278 U.S. 261, 49 S.Ct. 108, 73 L.Ed. 318 (1929):

> A state is without power to make or enforce any law governing bankruptcy that impairs the obligation of contracts or extends to persons or property outside its jurisdiction or conflicts with the national bankruptcy law.... The power of Congress to establish uniform laws on the subject of bankruptcies throughout the United States is unrestricted and paramount. Constitution, art. 1, s 8, cl. 4. The purpose to exclude state action for the discharge of insolvent debtors may be manifested without specific declaration to that end; that which is clearly implied is of equal force as that which is expressed.

### B. **No Ability to Pursue Federal Bankruptcy Preference Avoidance and Recovery**

Because section 547 of the Bankruptcy Code is only available in a bankruptcy case, a state court receiver does not have the ability to recover preferential transfers even if state law permits the avoidance and recovery of preferences. See Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198 (9th Cir. 2005), cert. denied, 546 U.S. 927 (2005) (holding that state preference laws are preempted by the Bankruptcy Code). An unsecured creditor faced with a receivership should weigh the likelihood of being a defendant in a preference action and the existence of significant preferential transfers to other unsecured creditors as it weighs whether or not a bankruptcy case is the preferred alternative for it.

### C. No Automatic Stay

Because section 362 of the Bankruptcy Code is only available in a bankruptcy case, a state court receivership cannot effectively prevent creditors from suing the borrower and obtaining judgments that thereby obtain priority in right of payment under state law. Federal courts, by way of contrast, can and do enjoin creditor action against the receivership estate. The inclusion of channeling injunction provisions in the receivership order may accomplish the similar goal of bringing all disputes before the receivership court, at least in federal court.

### D. No Rules Regarding Notice to Creditors, Claims Filing, or Objections

A significant concern to non-party creditors is the lack of common rules regarding the service of notice to creditors before the Receiver takes important action in administering the assets in the receivership estate. This can be ameliorated by the inclusion of notice provisions in the receivership order. However, the only parties likely to receive notice of the secured creditor's request for the appointment of a receiver are the defendants in the receivership action, and so unsecured creditors and other secured creditors commonly first learn of a receivership action when they receive a copy of the receivership order. Nevertheless, timely intervention and a request for modification of the receivership order may be more aligned with the creditor's interest than jumping to the conclusion that an involuntary bankruptcy is the preferred alternative. However, where the company is being liquidated, the bankruptcy court's established process and priorities are commonly more predictable than a state or federal receivership court that is not as accustomed to supervising liquidations.

### E. **No U.S. Trustee**

There is no U.S. Trustee equivalent in the federal or state receivership. The federal and state courts rely upon the receiver and the receiver's counsel to manage the process efficiently and expeditiously and, without the oversight provided by the U.S. Trustee, receiverships may linger beyond the time necessary and appropriate to accomplish their intended goal. The secured creditor whose collateral is being liquidated is, however, incentivized to closely monitor the receiver's progress and commonly does. But without a spokesperson for the unsecured creditors, there is no easy way to insure that the receiver maximizes a recovery beyond that necessary to satisfy the secured creditor.

### F. **Unclear if Property May be Sold Free and Clear of Liens Unless Secured Claims Are Paid in Full**

In Spreckles v. Spreckles Sugar Corp., 79 F.2d 332 (1935), where receiver sought to sell property free and clear of liens, Judge Learned Hand stated:

> We have no doubt that the power exists; the question is only as to the propriety of, and the proper conditions upon, its exercise. It is quite true, although there is perhaps no rigid rule about it, that ordinarily a court will not sell property free and clear of liens unless it can see that there is a substantial equity to be preserved.

Id. at 334.

Under Georgia Law, "[u]nless otherwise provided in the order, liens upon the property held by any parties to the record, shall be dissolved by the receiver's sale and transferred to the funds arising from the sale of the property." O.C.G.A. § 9-8-6. However, this may only be done where the lienholder is a party to the case "and the priority of the holder is carried over to the net proceeds of the sale." 2 Pindar's Ga. Real Estate Law & Proc. § 21-6 (6th ed.) (citing O.C.G.A. § 9-8-6; Ackerman v. Moon, 81 Ga.

688, 8 S.E. 321 (1888)); see also Empire Cotton Oil Co. v. Park, 147 Ga. 618, 95 S.E. 216 (1918); Denny v. Broadway Nat. Bank, 118 Ga. 221, 44 S.E. 982 (1903); McLaughlin v. Taylor, 115 Ga. 671, 42 S.E. 30 (1902). Further, any such sale by a receiver would be a sale in equity and thus appear to require confirmation of the sale by the court, O.C.G.A. § 23-4-35, at least where the receivership order does not contain pre-authorization of sales by the receiver. As mentioned in section I(B)(3) above, where the goal of the proceeding is to sell all or a portion of a business as a going concern, a purchaser is going to require title. Even if the law may allow a receiver to sell "free and clear" if there is not clear law from the highest court in the jurisdiction, a more robust sale could take place in bankruptcy where the law is more settled.

### G. No Clear Court Supervised Sale Process

Unlike section 363 of the Bankruptcy Code and Bankruptcy Rule 6004, the requirements for prior notice and an opportunity to object to receiver sales are left to the vagaries of the receivership order, which is often silent as to the procedure or expressly empowers the receiver to sell in public or private sale at his discretion.

## IV. Who May File a Bankruptcy Petition If a Receivership is Pending

### A. The Receiver

Provided the Receivership Order contains the appropriate language, or if not, the Receiver seeks and obtains an order from the appointing court, the Receiver may file a petition for relief on behalf of the business entity or entities that are in the receivership estate.

B. **The Debtor's Replaced Board of Directors, Management or Equity**

Because the bankruptcy courts look to state law to determine who has the power to commence a bankruptcy case, bankruptcy courts commonly conclude that the board of directors of a company that has a state or federal receiver may commence a bankruptcy case.

Although some deference is granted to Receivers appointed by federal district courts, bankruptcy courts are not as likely to prohibit a debtor's board of directors from resorting to bankruptcy on the grounds that the debtor is subject to a pending state court receivership action that purports to preclude interference with the Receiver by filing a bankruptcy petition. For example, in In re Automotive Professionals, Inc., 370 B.R. 161, 180-81 (Bankr. N.D. Ill. 2007), the bankruptcy court determined that an Order of Conservation issued by a state court that placed the assets and business of the debtor under the possession of the Illinois Director of Insurance did not preclude the debtor's directors and officers from filing a voluntary bankruptcy petition. The court went on to add that "the exclusivity of an administrative receiver's title to all assets under state law is irrelevant to the determination of whether a particular entity may file for bankruptcy relief .... Title 11 suspends the operation of state insolvency laws except as to those classes of persons specifically excluded from being debtors under the [Bankruptcy] Code." Id. at 181 (quoting In re Cash Currency Exch., Inc., 762 F.2d 542, 552 (7th Cir. 1985); see also In re Orchards VIII, Invs., LLC, 405 B.R. 341, 349 (Bankr. D. Or. 2009).

C. **Creditors**

Creditors have been enjoined from commencing involuntary bankruptcy cases by federal and state courts. However, appellate courts have been more willing to enforce

such provisions in federal than in state court orders. See Section V below.

## V. **Which Courts Enjoin Filing of a Bankruptcy Petition**

Federal courts in SEC cases may enjoin creditors from commencing involuntary cases against companies in the receivership estate. For example, the Second Circuit in the case of SEC v. Steven Byers, Wextrust Capital, LLC, et al., 609 F.3d 87 (2d Cir. 2010), joined the Ninth and Sixth Circuits in upholding an anti-bankruptcy injunction contained in a receivership order. Although indicating that this power should be used cautiously, the Second Circuit Court of Appeals held that district courts may issue anti-litigation injunctions barring bankruptcy filings as a part of their broad equitable powers in the context of an SEC receivership.

In contrast, in Gilchrist v. General Elec. Capital Corp., 262 F.3d 295 (4th Cir. 2001), a federal receiver was appointed under an order by the District of South Carolina that directed "'all persons'... not to file any action that 'affects' [the debtor's] assets." Id. at 297. A week later, creditors filed an involuntary petition in the Southern District of Georgia against the debtor. The Court of Appeals found that the mere fact that the receivership action was filed first had no bearing and that the automatic stay provision applied to the receivership action. Id. at 303-04 (holding the Bankruptcy Code is "unequivocal in its grant of exclusive jurisdiction to the bankruptcy court, and § 362(a) imposes an automatic stay on all proceedings merely upon the filing of a bankruptcy petition.... we believe it would frustrate Congressional intent to imply such a limitation based solely on consideration of a first-filed policy."); see also In re Corporate and Leisure Event Productions, Inc., 351 B.R. 724, 731 n. 26 (Bankr. D. Ariz. 2006) (declining to enforce a receivership order that precluded a bankruptcy filing, stating "It should go without saying that if removal of corporate officers and directors by a

receivership order were sufficient to prevent a bankruptcy filing, creditors who seek their state court remedies to the exclusion of all others would routinely obtain receivership orders with such boilerplate language."). The court in Gilchrist went on to state that even if there was not a jurisdictional issue, they did "not believe that the equities favor the common-law receivership process over the highly developed and specific bankruptcy process." Id. at 304. The court noted that the bankruptcy court was better suited to administering the assets of the debtor where the "procedural requirements for liquidating a large corporation with thousands of creditors, many of whom might challenge the priority of liens and the adequacy of asset sales, present a task that would push the receivership process to its limits." Id.

## VI. **Receiver as Debtor / Trustee**

Bankruptcy Code Section 105(b) does not permit the bankruptcy court to appoint a receiver in a bankruptcy case. Norton Bankruptcy Law and Practice 3d, §4:133. Early cases indicated that receivers should not act as debtors in possession. In Matter of Plantation Inn Partners, 142 B.R. 561 (Bankr. S.D. Ga. 1992), Judge Davis concluded:

> ... to permit the Receiver to indefinitely remain in possession and to vest him permanently with all the duties and powers of a debtor-in-possession goes far beyond the limited relief envisioned by Section 542. To do so would circumvent the prohibition of Section 105(b) against the appointment of receivers in lieu of a debtor-in-possession or trustee. Clearly the Code contemplates that the long-term administration of a Chapter 11 case will be managed by a trustee or debtor-in-possession, not a hybrid created by judicial fiat. *See Collier on Bankruptcy,* ¶ 1104.01[e] at 1104-29,30.

Although the U.S. Trustee has in the past objected to a receiver acting as trustee in a subsequent bankruptcy case, in recent practice, the U.S. Trustee seems to prefer having the receiver be appointed the trustee in a bankruptcy case commenced by the receiver. Citing the Second Circuit's decision in the case of Adams v. Marwil (In re Bayou Group,

LLC), 563 F.3d 541 (2d Cir. 2009), Grant Stein observes in his article entitled "The Intersection of Receiverships and Bankruptcy" published in the Volume 27, Number 4 issue of The Bankruptcy Strategist (February 2010), that a well drafted receivership order may enable a receiver to be appointed trustee in a bankruptcy case or otherwise remain in control. Stein cites several cases in which receivers filed bankruptcy cases and were subsequently appointed trustee including In re International Management Associates, LLC, No. 06-62966 (Bankr. N.D. Ga. Filed Mar. 16, 2006) (SEC receiver appointed trustee) and Rothstein Rosenfeldt Adler PA, No. 09-34791 (Bankr. S.D. Fla. Filed Nov. 10,. 2009) (state court receiver handling a Ponzi scheme consented to an order for relief and was appointed to serve as Chapter 11 trustee).

## VII. **Receiver As Custodian**

### A. **543 Turnover Issues**

Section 543 of the Bankruptcy Code governs the turnover of property by a custodian. Section 543 provides as follows:

> **(a)** A custodian with knowledge of the commencement of a case under this title concerning the debtor may not make any disbursement from, or take any action in the administration of, property of the debtor, proceeds, product, offspring, rents, or profits of such property, or property of the estate, in the possession, custody, or control of such custodian, except such action as is necessary to preserve such property.
> **(b)** A custodian shall--
> **(1)** deliver to the trustee any property of the debtor held by or transferred to such custodian, or proceeds, product, offspring, rents, or profits of such property, that is in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case; and
> **(2)** file an accounting of any property of the debtor, or proceeds, product, offspring, rents, or profits of such property, that, at any time, came into the possession, custody, or control of such custodian.
> **(c)** The court, after notice and a hearing, shall--

> **(1)** protect all entities to which a custodian has become obligated with respect to such property or proceeds, product, offspring, rents, or profits of such property;
> **(2)** provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such custodian; and
> **(3)** surcharge such custodian, other than an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, for any improper or excessive disbursement, other than a disbursement that has been made in accordance with applicable law or that has been approved, after notice and a hearing, by a court of competent jurisdiction before the commencement of the case under this title.
> **(d)** After notice and hearing, the bankruptcy court--
> **(1)** may excuse compliance with subsection (a), (b), or (c) of this section if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property, and
> **(2)** shall excuse compliance with subsections (a) and (b)(1) of this section if the custodian is an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, unless compliance with such subsections is necessary to prevent fraud or injustice.

Under section 543(d) the bankruptcy court may excuse compliance with the statute under certain circumstances and *may* allow a custodian, such as a receiver, to continue in his role "if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property." Further, the bankruptcy court *shall* allow the custodian to continue his role "if the custodian is an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, unless compliance with such subsections is necessary to prevent fraud or injustice."

Courts have held that Section 543(d), which allows a bankruptcy court to continue the prepetition receivership and to relieve a receiver from his duty to comply with the Bankruptcy Code's turnover and accounting requirements, is a modified abstention provision that reinforces policies set forth in the Bankruptcy Code section governing abstention. In re Lizeric Realty Corp., 188 B.R. 499 (Bankr. S.D.N.Y. 1995) (excusing the receiver from turnover of property because under the Bankruptcy Code, there is an exception to requirement that custodian of debtor's property who has knowledge of commencement of bankruptcy case turnover to debtor any assets of estate in his possession in cases where interest of creditors and equity security holders would be better served by permitting custodian to continue in possession).

In an unpublished Order addressing whether a receiver should be excused from compliance with Section 543(b), Judge Cox collected and listed seven factors that should be analyzed in determining whether the interest of creditors would be better served by permitting a receiver to continue in possession, custody, or control of a debtor's property. In re Falconridge, LLC, Chapter 11 Case No. 07-19200, Order dated November 8, 2007 (Docket No. 31), U.S. Bankruptcy Court for the Northern District of Illinois, Eastern Division. Judge Cox, noting that courts weigh a number of factors based on the specific facts of each case, collected the following seven factors from a variety of reported decisions:

a) The likelihood of a reorganization;

b) The probability that funds required for reorganization will be available;

c) Whether there are instances of mismanagement by the debtor;

d) Whether turnover would be injurious to creditors;

e) Whether the debtor will use the turned over property for the benefit of its creditors;

f) Whether or not there are avoidance issues raised with respect to property retained by a receiver, because a receiver does not possess avoiding the powers for the benefit of the estate; and

g) The fact that the bankruptcy automatic stay has deactivated the state court receivership action.

Falconridge Order, page 11-12 (citing Dill v. Dime Sav. Bank, 163 B.R. 221, 226 (E.D.N.Y. 1994); Lizeric Realty, 188 B.R. at 506-507; Northgate Terrace Apartments, 117 B.R. 328, 332 (Bankr. S.D. Ohio 1990); In re Poplar Springs Apartments, 103 B.R. 146, 150 (Bank. S.D. Ohio 1989); In re WPAS, Inc., 6 B.R. 40, 43-44 (Bankr. M.D. Fla. 1980)). Judge Cox further stated that "the paramount and sole concern is the interest of *all* creditors." Falconridge Order, page 12 (emphasis in original) (citing KCC-Fund V., Ltd., 96 B.R. 237, 239-40 (Bankr. W.D. Mo 1989)); and that the "interests of the debtor are not to be considered in the court's decision." Falconridge Order, page 12 (citing Dill, 163 B.R. at 225; Foundry of Barrington P'Ship v. Barrett (In re Foundry of Barrington P'Ship), 129 B.R. 550, 557 (Bankr. N.D. Ill. 1991)); see also In re Orchards Vill. Invs., LLC, 405 B.R. 351-354 (declining to require receiver to turn over assets of bankruptcy estate where debtor lacked income to fund reorganization, debtor's primary motivation for Chapter 11 filing was to protect interests of equity holders, and the evidentiary record reflected mismanagement of the assets prior to the Receivership).

B. **Abstention and Dismissal**

1. Factors for Dismissal

Section 305(a)(1) of the Bankruptcy Code provides that a Bankruptcy Court may dismiss any bankruptcy case at any time if "the interests of creditors and the debtor would be better served by such dismissal." The "prime congressional policy underlying

the abstention doctrine of § 305 is to prevent the commencement and continuation of disruptive involuntary cases." In re Weldon F. Stump & Co., 373 B.R. 823, 828 (Bankr. N.D. Ohio 2007) (exercising permissive abstention under § 305 where a state-court receivership action had already commenced).

The courts look to the totality of the circumstances to determine whether a bankruptcy should be dismissed under Section 305. A non-exclusive list of factors courts consider to dismiss any bankruptcy under Section 305 include:

a) economy and efficiency of administration;

b) whether another forum is available to protect the interests of both parties or there is already a pending proceeding in state court;

c) whether federal proceedings are necessary to reach a just and equitable solution;

d) whether there is an alternative means of achieving an equitable distribution of assets;

e) whether the debtor and the creditors are able to work out a less expensive out-of-court arrangement which better serves all interests in the case;

f) whether a non-federal insolvency has proceeded so far in those proceedings that it would be costly and time consuming to start afresh with the federal bankruptcy process; and

g) the purpose for which bankruptcy jurisdiction has been sought.

In re Paper I Partners, L.P., 283 B.R. 661, 679 (Bankr. E.D.N.Y. 2002); see also In re Fax Station, 118 B.R. 176, 177 (Bankr. D.R.I. 1990); In re Short Hills Caterers, Inc., 2008 WL 2357860, *4 (Bankr. D.N.J. June 4, 2008). In addition, the court in the case of In re Spade, 269 B.R. 225, 228-29 (D. Colo. 2001) determined that the involuntary bankruptcy petition was not in the best interests of creditors and should be dismissed based on the following factors: 1) the motivation of the parties; 2) the preference payments creditors sought to recover through the trustee were marginal in relation to

the administrative costs associated with such an action; 3) the cost and efficiency of administering the case in bankruptcy court; and 4) the prejudice to the other creditors by keeping the case in bankruptcy, which would shift the costs to all of the debtor's creditors.

2. Receivership as Another Available Forum

A dismissal under Section 305 is appropriate when there is another available forum. In re Macke International Trade, Inc., 370 B.R. 236, 247 (B.A.P. 9th Cir. 2007) ("Typical circumstances for dismissing under § 305 include the pendency of proceedings such as assignments for the benefit of creditors..., state court receiverships..., or bulk sale agreements."); In re Bailey's Beauticians Supply Co., 671 F.2d 1063 (7th Cir. 1982) (affirming the dismissal of an involuntary petition where debtor had executed an assignment for the benefit of creditors prior to the filing of a petition, finding that there would be a duplication of unnecessary expenses and undue delay); In re Silver Spring Center, 177 B.R. 759 (Bankr. D.R.I. 1995) (dismissing case filed by debtor shortly after the appointment of a temporary receiver in state court); In re Williamsburg Suites, Ltd., 117 B.R. 216 (Bankr. E.D. Va. 1990) (holding that the process of winding up of a partnership would not be better served under the bankruptcy process than under state law procedures); In re O'Neil Village Personal Care Corp., 88 B.R. 76, 80 (Bankr. W.D. Pa. 1988) ("Several courts have held that § 305 abstention or dismissal is appropriate when another forum is available to determine the parties' interests, and in fact, such an action had been commenced."); In re Tarletz, 27 B.R. 787 (Bankr. D. Colo. 1983) (holding it was appropriate to dismiss the case because the interests of the creditors and the debtor would be better served by such a dismissal, as there were adequate remedies available in a state court proceeding); In re Sun World Broadcasters, Inc., 85 B.R. 719

(Bankr. M.D. Fla. 1980) (dismissing an involuntary case because there was already a pending receivership); In re Short Hills Caterers, Inc., 2008 WL 2357860 *5 (noting that "courts generally dismiss an involuntary case under § 305(a)(1) where the debtor has made an assignment for the benefit of creditors") (citations omitted).

## Conclusion

While Bankruptcy Courts have the benefit of significant expertise and accordingly are the preferred venue for the reorganization or liquidation of companies in financial distress, in the appropriate case a state or federal equity receivership may be a less costly and more efficient process. Creditors who are not parties to a receivership may intervene and seek to have the receivership court modify the court supervised procedures to more closely follow the provisions of the Bankruptcy Code. Because a bankruptcy case is not easily dismissed once filed, stakeholders should communicate with each other and with the receiver in order to determine whether bankruptcy like protections can be grafted onto the receivership process by consent before jumping to the conclusion that a bankruptcy filing is the best course of action. However, where the receivership court is not inclined to act like a bankruptcy judge or the secured creditor who is the plaintiff in the underlying receivership action is unwilling to cooperate, a bankruptcy petition may be the best course.

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