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State law offers an alternative to Chapter 11

They sometimes offer a faster, cheaper alternative for the sale of distressed assets.

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The expensive administrative burdens of cases under Chapter 11 of the U.S. Bankruptcy Code have created among creditors renewed interest in state insolvency laws as alternatives for distressed-asset sales. Under the right circumstances, creditors can achieve significant cost savings by availing themselves of state court alternatives.

Chapter 11 was conceived as a mechanism for debtors and creditors to restructure debt through plans of reorganization that would establish a new contractual deal between the debtor and creditor constituencies. Section 363 of the code authorized the sale of assets but typically was used to sell individual assets rather than the entire enterprise of the debtor. In fact, early cases under the code required the showing of an emergency to sell substantially all the assets of the debtor. See, e.g., *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983). However, this approach changed rapidly. In recent years, many bankruptcies were largely controlled by secured lenders that were unwilling to fund a Chapter 11 case through a plan. Instead, they sought to quickly sell the entire going-concern enterprise through § 363 of the code, and then convert the case to a Chapter 7 proceeding. Today, the number of bankruptcy sales far outnumbers the number of bankruptcy restructurings.

Although a Chapter 7 trustee may be authorized to operate the debtor's business (see 11 U.S.C. 704(a)(8)), in many jurisdictions trustees choose not to do so because of potential liability. In such jurisdictions, Chapter 11 is the only option under the code for the sale of a business as a going concern. However, from the perspective of a secured creditor, many of Chapter 11's provisions, which were intended to ensure the fairness of a restructuring process, often frustrate their goal of efficiently selling the assets. For instance, during a Chapter 11 case, the debtor's management remains in control of the company. Achieving the cooperation of management often requires providing financial incentives, either through a carve-out of a portion of the sale proceeds, a release by the lender of personal guaranties or by pursuing a sale through a plan that provides a release for the management from other potential liabilities. Second, the code mandates the appointment of a committee of unsecured creditors. If the unsecured creditors are out of the money, they are likely to use the threat of litigation to obstruct or at least delay the sale process to negotiate a carve-out from the sale proceeds. Finally, the costs and expenses of lawyers and advisers can add up quickly in a Chapter 11 case. The costs of administering a Chapter 11 bankruptcy estate may represent a significant portion of any eventual sale proceeds, especially for small and midsize debtors.

FASTER, CHEAPER

State insolvency laws can provide lenders with a faster, cheaper alternative to the Chapter 11 sale process. Receivership laws typically provide for the assignment of the debtor's property to a third party, the receiver, who is authorized to operate and sell the debtor's property for the benefit of creditors.

> Important debtor rights may not be available in some states.

Receivership laws, or assignments for the benefit of creditors (ABCs), have roots in the common law and have been in use since the middle of the 19th century. Receivership laws often function as a hybrid of Chapter 7 and Chapter 11 by providing for the sale of a going-concern business without many of the administrative burdens presented by Chapter 11. In many cases, a stripped-down sale process under state law suits the needs of a lender better than a more robust, lengthy and costly Chapter 11 process.

Receivership laws vary significantly among states. A number of states, including Florida, Washington and Wisconsin, have enacted fairly sophisticated statutory receivership statutes. See Fla. Stat. ch. 727; Wash. Rev. Code § 7.60; Wis. Stat. § 128. Each of these statutes provide a court-supervised procedure that in many ways conforms to the familiar scheme of the Bankruptcy Code. Other states, such as Illinois, recognize ABCs as a common law out-of-court remedy but lack a supporting statute. Still other states either do not recognize receiverships or have laws that have fallen into disuse and are viewed with suspicion. In considering whether to pursue a receivership, it is important to consider the extent to which receiverships are used in the relevant state and the experience of the state's courts in administering receivership.

The receivership is commenced by filing with a general-jurisdiction state court. In some states, the receivership proceeding may be commenced voluntarily by the debtor by assigning its assets to a receiver. The assignee is then appointed as the receiver. A receivership can be initiated involuntarily by a complaint filed by a (usually secured) creditor, in which the creditor sues the debtor for nonpayment of debt and seeks the appointment of a receiver as a remedy. The receiver typically is an individual and usually is proposed by the party initiating the proceedings.

An order appointing a receiver establishes the duties and responsibilities of the receiver. The receiver is usually granted significant authority to continue the ordinary-course affairs of the debtor. When the lender and the debtor's management have an acrimonious relationship, control of the debtor by an independent third party can be a significant benefit for the lender. The receiver is not, however, an agent of the lender, but rather an officer of the court with a fiduciary duty to the estate as a whole. The receiver typically is also authorized by the court to hire his or her own professional advisers.

SECURING EARLY RELIEF

The availability of "first day" relief varies among jurisdictions. Courts in some jurisdictions will enter a first-day order providing for a stay on actions to collect debts from the debtor or the debtor's enterprise. When a stay is not available, the court may be willing to enter a channeling injunction, requiring claims to be litigated in the receivership action. Other relief often granted by courts includes authorization of post-petition financing, payment of prepetition claims of critical vendors, payment of prepetition employee claims and an order approving a sale process.

While state receivership proceedings are faster and less costly, it is important to note that some important debtor rights may not be available in some of them. For example, nonconsenting secured creditors may not be compelled to participate in a receivership proceeding. See *Wisconsin Brick & Block Corp. v. Vogel*, 54 Wis. 2d 321 (1972). Additionally, while Washington is an exception, see Wash. Rev. Code § 7.60.130, most receivership statutes do not provide for the assumption and assignment of executory contracts. A debtor with numerous leases, such as an owner of a shopping mall, or other important executory contracts may therefore be better served by a Chapter 11 filing. Although some states, such as California and Wisconsin, provide for the recovery of preferential payments, most states do not, which could result in an estate with fewer assets than would be available in a Chapter 11 proceeding.

Compared with Chapter 11, creditors have greater capacity to disrupt a receivership by filing pleadings external to the case. A disgruntled creditor in a receivership may seek remedies outside the receivership action, such as a foreclosure action, in the absence of a stay or channeling injunction. Creditors also may file an involuntary federal bankruptcy proceeding. The majority of bankruptcy courts hold that a timely commenced bankruptcy gives the bankruptcy court exclusive jurisdiction over the debtor. See, e.g., *In re Mid-City Parking*, 332 B.R. 798 (N.D. Ill. 2005). However, in some cases, bankruptcy courts have been persuaded to abstain pursuant to §§ 305 and 543(d) of the code and allow the receiver to continue to administer the debtor's enterprise.

Receivership proceedings are best suited for debtors with assets primarily located in one state. If significant assets are located outside the forum state, a receiver may be forced to rely on principles of "full faith and credit" to enforce court orders across state lines or initiate ancillary receivership proceedings in a different state. Another alternative is federal equity receivership, if federal jurisdiction is available. But federal receiverships are relatively rare, and most federal courts have crowded dockets and therefore may provide a less efficient forum than state courts. Thus, when the debtor has significant assets in a number of states, the parties most likely will decide to invoke federal bankruptcy jurisdiction to accomplish a sale under § 363.

Despite the limitations of receiverships, lenders are advised to consider using a receivership to take advantage of the speed and efficiency of the process. If circumstances permit, a sale can be closed within 30 to 90 days after the filing of the case, and with as few as two hearings. Lenders can thereby enjoy the benefits of a going-concern sale and preserve sale proceeds that would otherwise be used to fund the significant administrative costs associated with compliance with the U.S. Bankruptcy Code.

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