

Receiverships Offer Alternative to Bankruptcy Filing

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In a typical workout situation, restructuring professionals may find themselves involved in what becomes a battle between non-controlling investors and the controlling members of a struggling business.

Kept on the outside, disempowered and uninformed, non-controlling stakeholders feel mounting pressures to protect their investments in a timely fashion. Meanwhile, restructuring professionals find the business in acute financial distress, bleeding cash and experiencing rapidly deteriorating enterprise and asset values. Management is paralyzed in the face of seemingly insurmountable issues—loan defaults, vendors demanding cash on deliver (COD), fleeing customers and employees, and considerable litigation—and lacks the conviction or know-how to implement corrective actions.

At this critical point, non-controlling stakeholders must decide how best to pursue recovery of their investments. Traditional methods include collection efforts through state courts, foreclosure actions by secured creditors, and involuntary bankruptcy filings by unsecured creditors. However, receivership, a state court procedure widely used primarily in real estate restructuring matters, can be highly effective in situations involving operating businesses.

In its most basic form, a receivership is used to preserve the assets of a company or estate for the benefit of stakeholders. A judge may appoint a receiver to protect and preserve property or the rights of parties in the property, even if the action includes no other claim for relief. Receivers also may be appointed to preserve specific property that is the subject of litigation.

A receiver may be appointed by a judge at the request of a creditor who files an adversarial proceeding or through a stipulated order. The process of appointing a receiver often begins as an adversarial proceeding but, through effective negotiations by the parties and their professionals, concludes with a stipulated form of order.¹

The advantages of a receivership to creditors and other non-controlling stakeholders are the preservation of assets, the prevention of preferential payments, the assurance of equitable distribution of assets, and lower collection costs compared to a Chapter 11 or Chapter 7 case.

Level Playing Field

From a practical perspective, receiverships provide a level playing field for all stakeholders because a receiver is independent and impartial.² Based on a court order, a receiver assumes control of a company's cash accounts, assets, employees, and books and records. The individual effectively steps in as interim management to operate all aspects of a business or to liquidate assets, as the case may be.

¹ In an adversarial proceeding, stakeholders such as secured creditors may succeed in having a receiver appointed over a 14- to 30-day period, depending on the availability of the judge assigned to the matter.

² The requirement for a receiver to be a disinterested person may be waived by agreement of the parties, which differs from a formal bankruptcy proceeding. Often Receivers are hand picked by secured creditors, and thus may not be as "independent" as bankruptcy trustees (which is preferred by secured creditors).

A receiver acts in the best interests of all parties and therefore brings a fresh perspective and credibility to a troubled situation. A receiver can talk openly with employees, customers, and suppliers and often can negotiate with parties dispassionately to delay litigation and collection efforts, renew vendor relations, and resume the flow of product into the company, all while reassuring customers that orders will be fulfilled. These activities typically preserve enterprise and asset value so that assets may be sold or refinanced at values that exceed what they would bring in a forced liquidation.

Another important benefit is the ability to bring in new capital through the creation of a receiver's certificate, a court-approved funding mechanism that allows a troubled company to obtain working capital. Receiver certificates, which are typically issued with the cooperation of the secured creditor, are granted "super priority" status over the assets.

There are some disadvantages to receiverships. At any time during a receivership, a company can file Chapter 11, which would supersede the state court action. In addition, the protection of the automatic stay provided by the U.S. Bankruptcy Code, which halts pending litigation and prevents the filing of new civil actions, does not apply to a receivership. Finally, asset sales under the Uniform Commercial Code (UCC) may not provide the same protections to buyers with respect to title as a sale through a Bankruptcy Court. Under appropriate court orders, receivers may be empowered to sell assets (but they are not given "UCC" rights, which are rights that belong exclusively to secured creditors. There may be other disadvantages as well, depending on the situation.

To help ensure that a receivership is successful, the selection of a capable receiver is important. Key characteristics of a receiver include the ability to think and act independently of the parties in interest to ensure equitable positions for all stakeholders. Strong crisis management skills are essential because receivers must manage myriad employee, customer, and vendor issues that surface during the first week of receivership. These issues must be managed adroitly to regain the balance and direction needed to restore business operations and move toward breakeven or positive cash flow.

Financial expertise is required to quickly and accurately evaluate customer and product profitability, cash flow sources and uses, and a company's current financial position. Sufficient staffing is crucial to work with the competing interests vying for attention and hurling demands at the receiver's team. Finally, being a skilled communicator and having a wide range of experience as a receiver is helpful. Many hurdles must be overcome, and many individuals who can either help or hinder the process must be dealt with.

The receiver will seek out members of the company's marketing, sales, production, and finance teams to handle much of the heavy lifting that occurs during a receivership. Relying on key company staff members helps keep down the costs of a receivership and builds team spirit. Employees usually welcome a receiver who takes control and brings stability to the company.

Parties in interest and the court must agree on how receivers will be paid. Options include success fees, which may be a percentage of distributions to stakeholders; flat-rate fees per week or month; hourly rates; or other fee structures.

Historically, paying receivers hourly rates has worked best, probably because the structure provides no incentive for a receiver to show preference to one stakeholder over another by accepting particular asset sales or transactions. More importantly, the receiver

should not feel pressured to complete a deal simply for the sake of getting it done to earn a fee. However, attracting the best receiver candidates may be difficult unless a success fee or other form of compensation, besides hourly rates, is included in the fee package.

Termination

A receivership can be established and terminated relatively quickly, often at significantly less cost than bankruptcy or other forms of protracted litigation. Secured lenders sometimes request that a receiver be appointed to protect assets and collateral value in exchange for forbearance and additional funding. This allows a company to stay alive while the receiver takes over day-to-day operations of the business and ownership focuses on refinancing or obtaining new equity capital.

If the owners are successful and meet the debt obligation of the plaintiff (in most cases, the lender), the receivership may be terminated by agreement of both parties. Receivers may also sell assets under the UCC, which provides protection for buyers and sellers so that assets may be sold at fair value, as a means to end a receivership.

Receiverships ultimately are terminated by court order. The parties can either agree to terminate the receivership, or one party may ask the court to end it. Typically, receivers ask the court to terminate the arrangement after the assets have been distributed according to the receivership order.