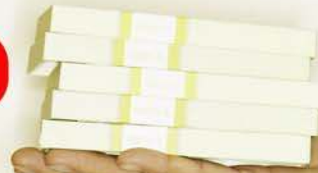
# RECEIVERSHIP



# A Value-Adding Tool

by Ken Philip and Kerin Kaminski

The time, cost and litigiousness of bankruptcy can make it a less-than-optimum alternative in a troubled company situation. A properly conducted receivership often provides a more flexible venue for problem resolution and value delivery. As a result, more and more stakeholders are exploring receiverships as an alternative.

**Alternatives to bankruptcy**

Turnaround consulting is often mistakenly viewed to be bankruptcy. In fact, good corporate-renewal consulting uses bankruptcy as only one of its tools, and then as sparingly as possible. Alternatives include pure out-of-court arrangements, and private or court-appointed receivers or receiver managers.

An out-of-court arrangement is the granddaddy of corporate renewal and turnaround work. This out-of-court process should be the mainstay of a middle-market corporate turnaround.

If a more formal procedure is required, a receivership, including state and federal court receiverships, can be one of the best vehicles for achieving commercially-driven solutions with minimum time and cost. They provide considerable flexibility not available in bankruptcy, and a substantially less adversarial environment. This most often translates into less time, improved outcomes, and reduced fees and costs.

**What is a receiver?**

A receiver is one placed in the custodial responsibility for the property of others, including tangible and intangible assets and rights. Once appointed, the entities of which he is receiver are said to be "in receivership".

The terms "receiver" and "receiver manager" are interchangeable. Traditionally, a receiver manager has been appointed when there is some expectation that the business will be operated, including potential sale as a going concern. A receiver has been appointed when the business is not expected to operate, but rather to give effect to a transaction, to conduct an orderly winding up, to act as a custodian in a dispute, etc. However, a receiver, once appointed, and assuming it was commercially reasonable to do so, could continue the operations of the business.

The purpose and nature of a receiver coming into being will provide the broader context of a receivership. Although there are various circumstances and varieties of receivers, this article concerns itself primarily with court-appointed receivers of operating businesses made up of one or more corporations.

There are three fundamental types of receiver appointments:

1. a receiver appointed by a (government) regulator pursuant to a statute;
2. a privately-appointed receiver; and
3. a court-appointed receiver.

Statutory appointments arise from state or federal laws which specifically provide for the appointment of a receiver. These include laws governing state-regulated insurance companies, healthcare companies, banking institutions, etc. While a statute may allow for the private appointment of a receiver (or may be silent on the method

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of appointment), these receiverships are often validated by a court appointment.

A privately-appointed receiver is based on a contractual agreement arising from a security interest and where the ability to appoint a receiver is specifically provided for in the security documents. Such an appointment is usually made simply by a letter from the creditor directed to and appointing the receiver and generally including some form of indemnity. The authority for the receiver's appointment and his powers are derived from the underlying financing or loan agreement. Privately appointed receivers are more common in jurisdictions that are less litigious, and/or have greater historical precedent, such as Europe, the UK and Canada.

Although court-appointed receivers are most often based on the petition of a secured creditor, anyone with a valid and quantifiable interest in the company can seek a court appointment of a receiver. A secured or other creditor with the contractual ability to (privately) appoint a receiver can apply to a court for a court-appointed receiver, the same as a party with the statutory ability to appoint a receiver.

Who can be a receiver? Technically there are very few limitations. A better question: Who *should* be a receiver? The best receivers are skilled turnaround consultants, but not all turnaround consultants are qualified to be receivers. Receivers must have an inherent understanding of the law, be quick on their feet, resourceful, ingenious and good business managers.

A receiver is more than the agent of the company. For all practical purposes his role supersedes existing management authority of the entity. The receiver controls all of the assets over which he is appointed, most often being all of the property of the business. The practical effect, therefore, is that only the receiver can run the business, or otherwise deal with the assets. The directors retain their statutory reporting responsibilities and must work with the receiver to fulfill them.

A receiver's powers flow from the document(s) underlying his appointment — a statute, financing agreement, or court order. In the case of a financing agreement or statute, the powers and available actions have been set out at the time of the document's preparation. In the case of a court appointment, the order setting out the authority is prepared concurrently with the petition for the receiver's appointment, and considerable flexibility within the law is available.

The quality of the order is critical. The only other factor of equal importance to the successful outcome of a receivership is the quality of the appointed receiver. As a result, considerable care should be taken in crafting the order.

A receiver is remunerated from the property over which he is receiver. This means that fees are paid out of corporate income or, failing that, by the secured lender or other party who has petitioned for the receiver. In the latter case, the creditor is entitled to add the payment to their claim. Fees should represent a priority claim and, in the case of a court appointment, this is generally provided for in the order. Like any other professional or supplier, receiver fees and expenses should be paid on reasonable terms. In the case of a court-appointed receiver, the court should not dictate fees, but rather leave such costs to be worked out between the commercial parties, while maintaining the court's jurisdiction over the receivership process.

At the appropriate time(s) the receiver will disburse the net proceeds from a receivership to valid creditors in the priority provided for by law. This includes paying secured creditors in order of their individual priority and to the extent of the realized value of their security. After secured creditors are paid, any surplus is distributed pro-rata to ordinary unsecured creditors. In the case of a court-appointed receiver, it is generally advisable for the receiver to inform the court of the details of payment(s) and seek an order approving them.

Once a receivership is completed, a receiver should be discharged from his duties. Depending on the type of receivership, this is accomplished either by a letter from the appointing creditor or by petition to and order of the court.

**On the ground: What does a receiver do?**

A receiver is responsible as a fiduciary for all of the assets of the receivership. His goal must be to maximize returns from these assets, either through a going-concern sale or liquidation.

A receiver's first actions are aimed at possession, protection and preservation of the assets. An exhaustive

discussion of all aspects of these actions is beyond the scope of this article. However, following are some key steps and considerations in this process:

1. Identification of all of the assets and their location(s). This includes bank accounts, accounting records and all other property.
2. Taking possession of the assets, including, as necessary, written notices, changing locks, placing security guards, mail redirection etc. A receiver is fiducially responsible for the receivership assets as soon as he becomes aware of his appointment. As a result, he must move expeditiously in the possession process to avoid any loss and potential negligence.
3. Reviewing insurance policies to be sure they are in force and adequate. Arranging for new or additional insurance as appropriate;

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4. Outstanding sales and purchase orders are not binding on the receiver unless he elects to accept them. As a result, in operating environments, incoming goods should be segregated. This will ensure appropriate treatment of pre- and post-receivership obligations.
5. Completion of an inventory of the assets, including accurate descriptions, serial numbers, etc. Depending on the size of the enterprise, this can take some time to finalize and, as a result, might continue after other initial steps are complete. This step also includes obtaining independent valuation(s) of the assets on an appropriate basis to be used in the receivership.
6. Opening new bank account(s) and setting up and maintaining new accounting records.
7. Communicating with employees, suppliers, creditors, unions and other stakeholders. The timing and nature of communication will be different in each situation. However, full and clear communication is the third vital link to a successful outcome. And, unlike the making of sausages, there are compelling reasons for transparency.

The next step is to determine the best course of action relative to continuing operations or otherwise. With respect to continuing operations, there are generally two considerations:

➤ Short-term operations to maximize value of inventories and accounts receivable. It may also be appropriate to continue operations on a short-term basis while the necessary information is developed to make a decision on the reasonableness of continuing operations longer term.

➤ Longer-term operations based on the profitability of the business and the effect on the value of the assets and ultimate recoveries.

The decision to continue operations can have many components (jobs, customers, politics, etc.) and in some cases these will be compelling. However, the primary driver of the decision must be maximization of the value of the assets and the recovery to creditors.

If operations are to be continued, the receiver will require working capital. In the absence of cash in the corporate kitty, secured creditors will advance funds for continuing operations. As in any commercial circumstance, this new financing will be based on a viable business plan presented by the receiver. Such advances are often acknowledged by receiver's certificates and, in any event, form a priority charge on the receivership assets (providing the new money the same priority as in a bankruptcy). This "new" lending arrangement should require reporting by the receiver against plan, and provides

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an appropriate degree of influence by a lender over the course of the receivership.

If the greatest value for the property of the business is on a break-up basis, then the receiver should move quickly to accomplish a liquidation. And liquidation always remains an option if operations do not meet goals set out in the receiver's business plan.

A liquidation process should not be lengthy. Liquidation of middle-market operating companies can generally be completed within 90 days, including collection of accounts receivable and sale of plant equipment. Real estate can obviously take somewhat longer. The vehicles for liquidation include private treaty sales, public auctions, etc.

Reporting is a critical component of any receivership. Whether court appointed or otherwise, a receiver should report on some regular cycle appropriate to the business and the purpose of the receivership. Normally this will be on

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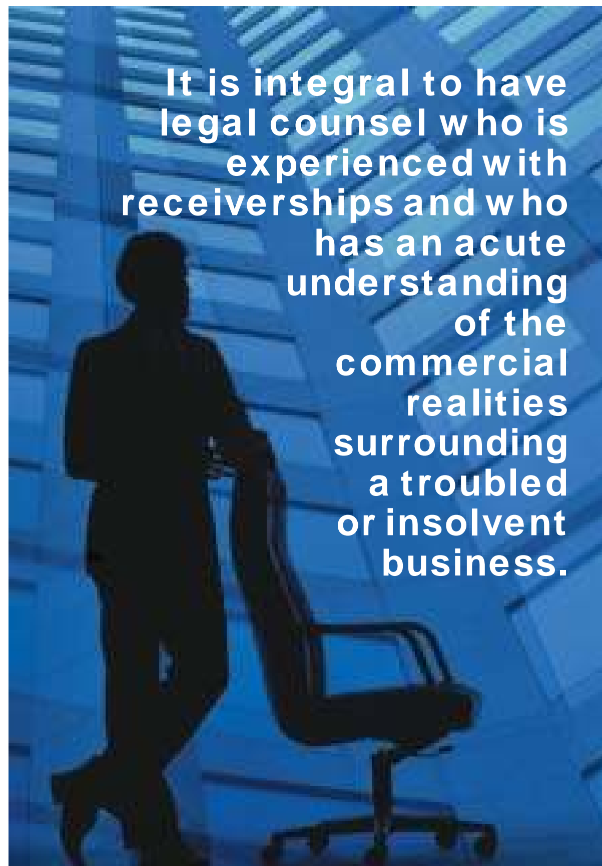
a similar cycle as financial statement preparation for the business, say every 30 days.

Reports should include written commentary updating all key issues, along with financial reporting against plan. The receiver's first report will represent the (business) plan for the receivership and, as such, will be more lengthy and detailed than subsequent reports. Court-appointed receivers will file their reports with the court and they become documents of public record.

Receivers have a responsibility to keep all affected parties advised of key actions and developments, and to seek approval for significant steps. In the case of a private appointment, this will very often be accomplished through oral and other reporting. In the case of a court-appointed receiver, this is accomplished by regular reports, or in separate filings as appropriate.




**Special considerations on court-appointed receivers**

It is integral to have legal counsel who is experienced with receiverships and who has an acute understanding of the commercial realities surrounding a troubled or insolvent business.

While this advice may seem obvious, there is a somewhat less obvious underlying issue. Receiverships have not been widely used in the U.S. since the 1930s when the Bankruptcy Act was amended with the addition of Chapter 11 reorganization provisions. Prior to that, receiverships were often used as a reorganization tool.

As a result, courts often do not have extensive experience or precedent relating to receiverships. In such an environment, experienced legal counsel is critical to overcoming objections and assisting the court to understand the reasons and importance of granting an order.

For obvious liability reasons, banks and others do not make receivership applications lightly. When they move for a receiver, it is most often because there are underlying urgent commercial issues. In such cases, and should the appointment be objected to, legal counsel must be able to demonstrate to the court the compelling time and other issues calling for the appointment.

In most circumstances, a receivership order should be granted on application. Although there can be reasons for a court to deny granting an order, they do not include a debtor's lament that the appointment of a receiver will damage him or the company. Remember that the debtor can be indemnified by the bank if the appointment turns out to have been improvident, whereas the bank most often cannot be made whole by the debtor. If there is any uncertainty as to course, considerations regarding preserving jobs and otherwise can generally be dealt with by wording in the order and by remembering that the receiver is an independent fiduciary responsible to the court, with an equal duty to all stakeholders to make commercially reasonable and supportable decisions.

Finally, some courts appoint receivers other than the one recommended by the petitioning creditor. This can have the unfortunate and unintended result of receivers being appointed who do not have the necessary skills and experience for the particular business at issue. A court should take into consideration the observations and recommendations included in this article. As a fundamental matter, creditors should argue strongly for a receiver of their choice. Counsel must impress upon the court the necessity of appointing a professional and experienced receiver, one familiar with the required tasks.

**Is a receivership for you?**

In insolvency, as with many business decisions, there is often no right or wrong answer. Generally a formal insolvency proceeding is selected to bring order to a potentially uncertain and chaotic situation, to protect fresh loan advances, and to provide for an equitable venue. An out-of-court process will have been considered and eliminated.

There are clearly circumstances where a bankruptcy is called for. These include broad competing jurisdictions or other complex situations. However, on the continuum of troubled company solutions, receivership should be considered first, with bankruptcy being a last resort.

No receivership appointment or other formal insolvency proceeding should be commenced without a Plan A

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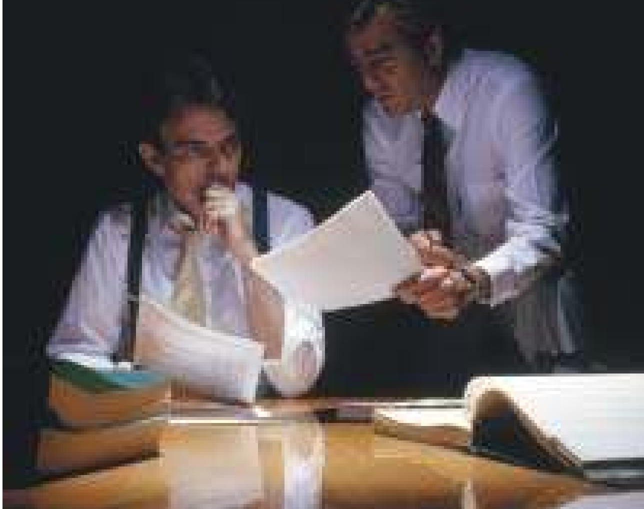


and a Plan B. In the case of court-appointed receivers, whether statutory or otherwise, the court can be expected to make at least cursory inquiry to ensure that the process is not precipitous and that a strategy exists which has a chance of creating a commercially reasonable outcome. This includes ensuring that the applicant and receiver understand their responsibilities and are appropriately experienced.

Any formal insolvency proceeding (receivership, bankruptcy, etc.) should be a last resort. Ideally, the lender will have had the opportunity (read: "time") to have an independent assessment completed prior to such proceeding. Often a receiver's appointment will arise out of such an assessment where an independent consultant makes such a recommendation. If the consultant has done his job, the company may already be conditioned to a solution involving a receivership and a consent appointment can be arranged.

Some receiver appointments may be on an "emergency" basis, where a payroll must be met in an uncertain business environment, or where an appointment is required to stabilize a rapidly deteriorating or hostile situation. There may also be circumstances where the most reasonable course is a sale transaction or liquidation, and a receiver is sought to complete this process, and to be a referee between stakeholders. It is important to note that receivers can deliver free and clear title to assets.

Any of these circumstances can be achieved expeditiously and cost effectively by a receiver. In considering what action to take, the key is to avoid defaulting to a bankruptcy, and to first ask: Will a receivership work? In a great number of cases the answer will be yes.

**A well-conducted receivership: What to expect**

Remember, a receivership is not a bankruptcy. No "First Day Orders", no creditors' committees, and no carve-out debates.

You should expect a solution delivered with commercial speed, conducted in a professional and orderly manner, without surprises, and at a notably reduced cost compared with a bankruptcy.

A receivership should be driven by business issues rather than legal ones. A problem-loan situation is fundamentally a commercial problem requiring a commercial solution. By the nature of the problem, it requires primarily business experience and judgment. Creditors and other stakeholders should expect no less independent and competent action from the receiver than from an experienced turnaround consultant or other professional.

The conduct of a receiver, whether court-appointed or otherwise, should be above reproach. A court -appointed receiver is an officer of the court. All receivers should, in addition to adhering to the code of conduct of their profession, conduct themselves as though they were court-appointed. In summary, as a fiduciary on behalf of all stakeholders, a receiver's conduct should be held to the highest ethical and commercial standards, not only because it is the right thing to do, but also because it is required to protect the integrity of the process and parties.

**Summary**

When considering the alternatives in a troubled company situation, it is best to avoid the rush to any formal insolvency process. A sick company should be returned to health with minimum invasiveness. If an out-of-court arrangement is not workable, and a formal controlled process is required, then a receivership is the next least invasive.

A properly conducted receivership provides for a level and secure playing field based on the general ranking of creditor claims. And it can do so without unnecessary dissipation of asset values through time and costs.

In a well-conducted receivership, any commercially reasonable outcome can be achieved – rehabilitation, sale, liquidation. This can be accomplished providing the same security to fresh advances as in a bankruptcy, and without the attendant time and money issues inherent in a bankruptcy.

Four factors are of key importance: a competent and experienced receiver; legal counsel who understands insolvency and its urgency; open and thorough communication; and, in the case of a court appointment, a properly constructed order.

In short, receivership is a demonstrated value-adding tool that should not be overlooked when staring down the barrel of a distressed company. ▲

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