

Dueling Proceedings Between Bankruptcy And Receiverships

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I. Dueling Proceedings Between Bankruptcy And Receiverships¹

The accompanying article, *Receiverships*, has introduced the principles of receiverships and has discussed the uses and complexities of receiverships as they appear in state courts, federal courts, and abroad. This Article will now explore receiverships within the context of their interaction and potential collision with a proceeding under the Bankruptcy Code as well as how the roles of parties-in-interest – particularly, creditors and equity investors – differ when they participate in a receivership as compared to a bankruptcy proceeding.

A. When A Bankruptcy Proceeding And A Receivership Collide

In recent history, the collision of a receivership and a bankruptcy proceeding was a rare event. When a receivership and a bankruptcy proceeding did collide, the result pitted a federal district court or state court against a bankruptcy court.² Nevertheless, the collision of a receivership and a bankruptcy proceeding seems not to have occupied much attention. However, in the wake of the recent economic meltdown and the credit crisis that followed, there has been an increase in the use of SEC-initiated receiverships.³ Separately, after the crash of the commercial real estate market and in light of the 2005 amendments to the Bankruptcy Code that have limited a debtor's flexibility in single asset entity proceedings, state court receiverships of such entities have become more common.⁴ Together, the opportunity for an increase in the collision of receiverships and bankruptcy proceedings appears inevitable and potentially more challenging than in prior history.

Accordingly, in an effort to equip practitioners with the basic skills necessary to maneuver through this collision, this section of the Article will first discuss issues arising when a federal receivership commenced at the request of the SEC or other governmental unit collides with a pending bankruptcy proceeding. It will next discuss issues arising from a state court receivership colliding with a pending bankruptcy proceeding. Finally, it will discuss issues arising from a bankruptcy proceeding colliding with a pending receivership.

¹ The authors wish to thank Lee J. Pannier of Munsch Hardt Kopf & Harr, P.C. for his significant contributions to this Article.

² For a thorough discussion of this conflict in the mid-1970s, see Schwartz, *Termination of SEC Receiverships in the Federal Courts*, 75 Fordham L. Rev. 163 (1974-75).

³ The Securities Act of 1933 and the Exchange Act of 1934 expressly grant district courts the authority to issue injunctive relief for securities violations and/or fraud. See 15 U.S.C. § 78u(d) and (e); § 80b(d). Moreover, the SEC commonly seeks ancillary relief – namely, the appointment of a receiver – in addition to the issuance of an injunction. Typically, receiverships are viewed as an extreme remedy. However, a district court will likely appoint a receiver at the SEC's request when necessary to preserve the *status quo* or to address the threat of diversion or waste of assets. Accordingly, a district court is very likely to appoint a receiver at the SEC's request when the SEC alleges securities violations and/or fraud and the need to maintain the assets and operations or prevent any threat of the same.

⁴ See, e.g. M. Colette Gibbons and Jason D. Grimes, *A Model Statute for Free-and-Clear Sales by Equity Receivers*, 28-2 ABIJ 50 (Mar. 2009); Stuart Walzer, *A Primer on Receiverships*, 10 LITIGATION 29 (1983); David L. Abney, *Selling Equity Receivership Property Free and Clear of Liens and Encumbrances*, 16 REAL EST. L.J. 364 (1988); Paul A. Lucey, *The Liquidating 'Chapter 11' in State Court*, 20-Feb AM. BANKR. INST. J. 12 (2001); Skeel, *The new (and Very Old) State Law Technique for Restructuring Troubled Companies*, American Bankruptcy Institute (2006), www.abiworld.org (click "search" and type in "very old") (last visited Oct. 21, 2010).

1. When A Federal Receivership Commences When A Bankruptcy Proceeding Is Pending

When a federal equity receivership, including the sorts of receiverships initiated at the request of the SEC to address violations of securities laws, occurs when a bankruptcy proceeding is pending, the parties in both proceedings are immediately faced with a wide variety of questions and several difficult (and largely uncharted) paths from which to choose. Such questions and choices typically must be made and answered quickly because the federal receiver usually comes armed with a broad order that can, and likely will, freeze all the debtor's assets, purport to remove the debtor-in-possession and possibly its management and professionals, and take control of the debtor's business and assets.

a. Can A Receiver Appointed At The Request Of A Governmental Authority Simply "Commandeer" A Bankruptcy Proceeding?

Like most answers in life and law, the answer to this question is a simple "Yes . . . but . . ." The "yes" arises from section 362(b)(4) of the Bankruptcy Code, which creates a "government authority exception." This exception creates an opening by which a receiver appointed at the request of a governmental unit (such as the SEC) can essentially commandeer control of assets and liabilities of a bankrupt debtor without violating the automatic stay. As described by the legislative history behind section 362(b)(4) of the Bankruptcy Code, "where a governmental unit is suing a debtor to prevent or stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay."⁵

However, the "but" following the "yes" above arises from the exception to the "government authority exception." Specifically, the "money judgment exception" to the "government authority exception" provides that a government unit may enforce its regulatory and police powers without violating the automatic stay, "including the enforcement of a judgment *other than a money judgment*."⁶ As a result, this exception to the exception may limit the powers of a receiver appointed at the request of a governmental unit because, although the "government authority exception" likely allows a receiver to enforce the order that created the receivership and froze the debtor's assets, the "money judgment exception" may, in some districts, prevent the receiver from seizing or otherwise taking any actions to distribute or spend the debtor's assets.

The "may" in the foregoing sentence is the critical inquiry that must be answered in order to determine whether a receiver can commandeer the debtor's assets and liabilities. Furthermore, the "may" remains an open issue because few courts have directly addressed a receiver's power after stepping into a bankruptcy proceeding and the one Circuit Court that directly addressed the

⁵ H.R. Rep. No. 95-595, at 343, U.S. Code Cong. & Admin. News at 6299.

⁶ 11 U.S.C. § 362(b)(4) (emphasis added).

issue could not unanimously decide whether the “money judgment exception” essentially handcuffs a receiver appointed at the request of a governmental unit in a bankruptcy proceeding.⁷

The majority in *SEC v. Brennan* drew a “line in the sand” when it ruled that the “money judgment exception” to the “government authority exception” in section 362(d)(4) of the Bankruptcy Code precluded the SEC-appointed receiver from enforcing a money judgment against the debtor or seizing the debtor’s assets from administration of, and distributions in, the receivership. The rationale behind this “line in the sand” was described as follows:

up to the moment when liability is definitively fixed by entry of judgment, the government is acting in its police or regulatory capacity-in the public interest, it is burdening certain conduct so as to deter it. However, once liability is fixed and a money judgment has been entered, the government necessarily acts only to vindicate its own interest in collecting its judgment. Except in an indirect and attenuated manner, it is no longer attempting to deter wrongful conduct. It is therefore no longer acting in its “police or regulatory” capacity, and the exception to the exception does not apply.⁸

The dissent, following earlier cases, drew a different line in the sand. Based on its interpretation of section 362(d)(4) of the Bankruptcy Code, as well as the legislative history and Congressional intent behind the same, the dissent contended that the “money judgment exception” should differentiate between the collection of a money judgment and the seizure of the debtor’s assets. In other words, the dissent contends that the SEC-appointed receiver should be allowed to control the debtor’s assets and to seize and transfer such assets as long as the government is not putting on its “creditor’s hat” and attempting to seize the assets, or a portion thereof, *for itself* and, thus, attempting to trump or side-step the Bankruptcy Code and Bankruptcy Rules to the detriment of parties in interest in the bankruptcy case. Several courts have applied the rationale of the *Brennan* dissent.⁹

b. A Proactive Approach: Withdrawal Of The Reference

In lieu of waiting for the bankruptcy court (or, as necessary, an appellate court) to decide the scope of a receiver’s powers, a receiver or any other party-in-interest could move to

⁷ *SEC v. Brennan*, 230 F.3d 65 (2nd Cir. 2000). *See also, United States ex rel. Fullington v. Parkway Hospital (In re Parkway Hospital, Inc.)*, 351 B.R. 280 (E.D.N.Y. 2006) (allowing the SEC action against the debtor to proceed under the “government authority exception” after the commencement of the bankruptcy proceeding, but applying the “money judgment exception” to limit a *qui tam* plaintiff’s ability to do more than obtain an entry of a judgment against the debtor).

⁸ *SEC v. Brennan*, 230 F.3d at 73.

⁹ *See, e.g., SEC v. Wolfson*, 309 B.R. 612 (D. Utah 2004) (holding that the “government authority exception” permitted the district court to appoint a receiver over defendants in a SEC civil fraud action who subsequently commenced a bankruptcy proceeding); *SEC v. Elmas Trading Corp.*, 620 F.Supp. 231, 240-41 (D. Nev. 1985) (finding that the automatic stay did not stay the SEC’s motion to expand the scope of the receivership to include certain entities that recently filed bankruptcy proceedings); *CFTC v. CoPetro Mktg. Group*, 700 F. 2d 1279 (9th Cir. 1983) (upholding the appointment of a receiver over the debtor’s assets and finding that such actions did not constitute the enforcement of a money judgment which would violate the automatic stay); *Securities & Exchange Comm’n v. First Fin. Group of Tex.*, 645 F.2d 429 (5th Cir. 1981).

withdraw the reference. Section 157(d) of title 28 of the United States Code allows, and under certain circumstances requires,¹⁰ a federal district court to withdraw the reference to the bankruptcy court.¹¹

Specifically, a district court may withdraw the reference if the receiver or other party-in-interest can demonstrate that “cause” exists for such withdrawal, and in some situations must withdraw the reference. As to permissive withdrawal, courts have created a variety of factors to consider in determining whether to grant the withdrawal: (i) whether the proceeding is non-core and the parties have not consented to the bankruptcy court’s entry of final orders; (ii) whether jury rights are involved and whether the bankruptcy court is authorized to conduct a jury trial; (iii) whether a resolution of the proceeding will require substantial and material interpretation of non-bankruptcy federal statutes having more than a *de minimis* impact on interstate commerce; (iv) whether the interests of judicial efficiency and economy are served; (v) whether the interest of uniformity in the bankruptcy process is served; and (vi) whether a party is undertaking forum shopping.¹²

A district court *must* withdraw the reference if the motion is timely and the bankruptcy proceeding requires substantial consideration of both title 11 and other laws of the United States affecting interstate commerce. To determine whether a motion to withdraw the reference is timely, courts focus on whether the motion for withdrawal of the reference “was made as promptly as possible in light of the developments in the bankruptcy proceeding.”¹³ Application of this standard is necessarily case and fact specific.

Furthermore, as stated by section 157(d) of title 28 of the United States Code, a district court “shall” grant a motion for withdrawal of the reference when the proceeding proposed to be withdrawn “requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.”¹⁴ Courts generally interpret the mandatory withdrawal provision restrictively, granting withdrawal of the reference when the

¹⁰ As a general matter, Title 11 cases are referred to bankruptcy judges pursuant to 28 U.S.C. § 157(a). Most federal districts accomplish this through standing orders of reference. In the Northern District of Texas, for example, “cases under Title 11 and any or all proceedings arising under Title 11 or arising in or related to a case under Title 11” are automatically referred to the bankruptcy court pursuant to that certain Standing Order dated August 3, 1984.

¹¹ Section 157(d) provides that:

[t]he district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on the timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.

28 U.S.C. 157(d).

¹² See, e.g., *id.* See also *Holland Am. Ins. Co. v. Succession of Roy*, 777 F.2d 992, 998-99 (5th Cir. 1985); *In re TPI Intern. Airways*, 222 B.R. 663, 668 (S.D. Ga. 1998).

¹³ *Official Comm. of Unsecured Creds. v. Amlicke (In re VWE Group, Inc.)*, 359 B.R. 41, 446-47 (S.D. N.Y. 2007). See also, *In re Texaco Inc.*, 84 B.R. 911, 919 (S.D. N.Y. 1988) (stating that a motion for withdrawal of the reference is timely if made “as timely as possible in light of the status of the bankruptcy proceeding”); *In re Giorgio*, 50 B.R. 327 (D. R.I. 1985) (stating that the court will interpret “timely as being at the first reasonable opportunity”).

¹⁴ 28 U.S.C. § 157(d).

claim and defense entail material and substantial consideration of non-Bankruptcy Code federal law.¹⁵ It would seem that in the context of a receivership involving the federal laws of securities regulation and commodities regulation, a related bankruptcy proceeding would entail substantial consideration of non-Bankruptcy Code federal law.

Importantly, however, the withdrawal of the reference does not terminate the bankruptcy proceeding (because jurisdiction over bankruptcy cases resides originally in the district court). Rather, it changes the court conducting (or at least making the binding rulings in) the proceeding. It would be hoped that if the rulings are to be made by the district court, either that court would transfer the bankruptcy proceeding to the district court in which the receivership is pending (or would otherwise create one presiding court over the situation), thereby avoiding the possibility of two different judges approaching the same situation in different ways.¹⁶

c. A Compromise: Allowing The Receivership And The Bankruptcy Proceeding To Co-Exist

As an alternative to a potentially lengthy and expensive legal fight over whether a receiver can take control of the assets and liabilities of a bankrupt debtor or whether the district court should or must withdraw the reference, the potentially numerous parties-in-interest in the bankruptcy proceeding and the receivership can attempt to find a basis on which they can coordinate the proceedings. Although allowing the receivership and the bankruptcy proceeding to co-exist may optimize the gathering and preservation of assets, and the distribution of the proceeds, while reducing the amount of litigation expenses, working together is often times easier said than done and involves several critical components, not the least of which is unanimous or virtually unanimous agreement between the principal parties.

First, because a receivership and a bankruptcy proceeding in most cases conflict with each other,¹⁷ working together requires all the principal parties (*e.g.*, the receiver and any entity that obtained the appointment of the receiver, all of the official committees in the bankruptcy proceeding, the debtor in possession or the trustee acting in the bankruptcy case, the United States Trustee, and both the district court and the bankruptcy court) to agree to play by the same rules.

¹⁵ *Levine v. M&A Custom Home Builder & Developer, LLC*, 400 B.R. 200, 203 (S.D. Tex. 2008) (citing *Lifemark Hosps. of La., Inc. v. Liljeberg Enters., Inc.*, 161 B.R. 21, 24 (E.D. La. 1993) (withdrawing the reference when case involved the determination of antitrust claims)). See also, *U.S. Gypsum Co. v. Nat'l Gypsum Co.*, 145 B.R. 539, 541 (N.D. Tex. 1992) (withdrawing the reference when case involved the determination of patent claims); *In re Johns-Manville Corp.*, 63 B.R. 600, 603 (S.D. N.Y. 1986) (withdrawing the reference when case involved the determination of CERCLA issues); *In re White Motor Corp.*, 42 B.R. 693, 704 (N.D. Ohio 1984) (electing not to withdraw the reference based on speculation about issues under ERISA and Internal Revenue Code which may or may not be germane to the core proceeding).

¹⁶ One example of such a coordinated approach is illustrated by the joint administration order in the *Lancer* cases. See Order dated August 19, 2004 in *SEC v. Michael Lauer, et al*, U.S. Dist. Court, S.D. Fla., Case No. 03 80612 CIV-MARRA, and *In re Lancer Partners L.P.*, U.S. Dist. Court, S.D. Fla., Case No. 03 80611 CIV-MARRA, Order Granting Receiver's Motion for Joint Administration of Receivership and Bankruptcy Estates.

¹⁷ For instance, in a receivership commenced at the request of the SEC, the SEC is likely to seek a recovery primarily for the benefit of investors, whether those investors hold debt or equity, while a bankruptcy proceeding's priority scheme inures first to the benefit of creditors, then to equity holders.

As with most rules, the benefit is not the actual rules themselves, but rather that they provide a structure or playing field that all the constituents endeavor to abide by. These rules appear in these cases as “protocols” between two courts in related proceedings, agreed to by the parties. In some situations, as has been observed in the *Lehman* cases, the set of rules can prove to be unhelpful and can be subject to criticism.¹⁸ In other cases, however, where all of the parties who wish to express views agree on the protocols, they can be particularly helpful.

For instance, in *In re Provident Royalties, LLC, et al.*,¹⁹ a recent case before the United States Bankruptcy Court for the Northern District of Texas, the Honorable Judge Hale presiding, a protocol was developed, agreed upon and entered in the bankruptcy proceeding and the receivership.²⁰ This protocol was not an elaborate set of rules. Rather, it was a simple agreement among all the major constituents in the bankruptcy proceeding and the receivership, which allowed the bankruptcy to proceed under the rubric of the Bankruptcy Code and with the receiver as the Chapter 11 Trustee while, at the same time, allowing the receivership to proceed under the rubric of the Receivership Order appointing the receiver before the district court.²¹ In short, this simplified the administration of the proceedings by permitting a receiver appointed after the bankruptcy case had begun to control the debtor’s assets by acting in (and pursuant to) the bankruptcy process. Although the Protocol was far from perfect, it created a set of fundamental rules that everyone agreed to follow and that allowed both the bankruptcy proceeding and the receivership to peacefully co-exist.²²

¹⁸ See, e.g., Baird, Beveridge, DeKoven, Dick, Semenko and Shimshak, *Restructurings in Europe*, American Bankruptcy Institute, International Insolvency and Restructuring Symposium (2010). (“Unfortunately, the success of the Lehman protocol is disputed, with some practitioners taking the view that the document is too high level and aspirational to be really helpful to creditors. In fact, the administrators appointed over the English entities have not yet signed it.”)

¹⁹ *In re Provident Royalties, LLC, et al.* is being jointly administered under Case No. 09-33886.

²⁰ The Protocol is attached.

²¹ Specifically, the Protocol: (i) appointed the Receiver as the Chapter 11 Trustee; (ii) allowed the Receiver to continue acting as the Receiver with all the powers granted to him by the Receivership Order for the non-debtor defendants in the receivership; (iii) effectively segregated the Bankruptcy Cases from the Receivership by providing that: (a) all the Debtors’ assets would be administered and distributed in accordance with the rules and priorities set forth in the Bankruptcy Code; and (b) all the assets of the non-debtor defendants in the receivership would be administered and distributed pursuant to the Receivership Order; (iv) allowed the Receiver to pursue all actions to recover the Receivership Defendants’ assets from third parties without violating the automatic stay (effectively expanded the reach of the Chapter 11 Trustee); (v) reserved all parties’ rights to contest the allocation of assets between the Receivership and the Bankruptcy Cases; and (vi) provided that the SEC and the Receiver would consent to the Creditors’ Committee’s intervention in the Receivership for limited purposes – e.g., protecting the rights of general unsecured creditors.

²² In addition to being useful to navigate dueling bankruptcy and receivership proceedings, protocols can be useful in many situations. For instance, historically, they were used to identify for bankruptcy courts in different jurisdictions their allocation of responsibility under former Section 304 Proceedings and current Chapter 15 proceedings. Additionally, they can be useful in cross-border insolvency proceedings. Furthermore, protocols can be used to address potential points of conflict, such as: (i) which court has responsibility over which entities and/or proceeding; (ii) which court has authority over what property (whether by geographical scope or otherwise); (iii) which party or parties have the right to develop a plan of liquidation or reorganization and which court will hear the same; (iv) which party or parties have the power to administer distributions under the plan and which court will have the power to police same; (v) which party or parties have the right to recover estate property from third-parties and

2. When A State Court Receivership Commences When A Bankruptcy Proceeding Is Pending

If the receivership is in a state court, then the Supremacy Clause of the U.S. Constitution ordinarily dictates that the bankruptcy proceeding is the dominant proceeding.²³ Furthermore, provided that the state court receivership is commenced by a creditor or other non-governmental unit (as is typical with state court receiverships), the automatic stay will likely prevent the state court receivership from interfering with the bankruptcy proceeding. Moreover, the commencement of a state court receivership itself may be a violation of the automatic stay that could expose the creditor or other non-governmental entity to sanctions and other penalties for violating the automatic stay.²⁴

3. When A Bankruptcy Proceeding Commences When A Receivership Is Pending

The common answer in this case is that the receivership is stayed,²⁵ the receiver is treated as a custodian of assets (under Section 543 of the Bankruptcy Code) and may be ordered by the bankruptcy court to turn over assets in the receivership. But the first question is, as always, whether the bankruptcy proceeding has been properly commenced. The answer to the question lies in who has authority to file the bankruptcy proceeding.

a. The Receivership Order

The answers to these multi-tiered questions will be influenced (and may be dictated) by the receivership order. Typically, the representatives, principals, and/or officers and directors of the entity that is the subject of the receivership may well have no remaining power or authority to commence a voluntary bankruptcy proceeding because, simply put, the receivership likely stripped those parties of the authority to run day-to-day operations of the business.²⁶ Instead, the receivership order may give the receiver exclusive power to commence a bankruptcy proceeding,

which court will adjudicate the same; and (vi) which party or parties have the right to determine the amounts of asserted claims and which court will hear the same.

²³ See cases cited in note [24] *infra*. Sometimes, however, such a result does not follow. See generally Shine, *Receiverships Survive Pre-emption Attack*, 41 RI Bar Jnl. 11 (1999).

²⁴ See generally 11 U.S.C. § 362(a), subject to the exceptions noted therein.

²⁵ See, e.g., *Cash Currency Exch. Inc. v. Shine (In re Cash Currency Exch. Inc.)*, 762 F.2d 542, 552 (7th Cir. 1985) (stating that “the exclusivity of an administrative receiver’s title to all assets under state law is irrelevant to the determination whether a particular entity may file for bankruptcy relief. . . Title 11 suspends the operation of state insolvency laws”); *In re S & S Liquor Mart Inc.*, 52 B.R. 226, 227 (Bankr. D.R.I. 1985) (stating that “a state court receivership proceeding may not operate to deny a corporate debtor access to the federal bankruptcy courts”); *In re Donaldson Ford Inc.*, 19 B.R. 425, 428-29 (Bankr. N.D. Ohio 1982) (stating that “the pendency of an equity receivership will not ordinarily prevent a corporation from filing a voluntary petition in bankruptcy”); *State of Tex. v. Porter (In re White Start Ref. Co.)*, 74 F.2d 269, 271 (5th Cir. 1934) (holding that general receivership “falls before a bankruptcy”).

²⁶ However, such lack of authority does not mean that the entity that is subject to a receivership cannot become a debtor in a bankruptcy proceeding. If the properly authorized managers (most commonly directors or limited liability company managers) of the entity that is the subject of receivership retain enough power to commence a bankruptcy proceeding, the receivership will likely yield to the bankruptcy proceeding.

restrict or enjoin or even prevent parties from filing a voluntary proceeding, and enjoin third-parties from filing an involuntary bankruptcy proceeding against the subject of the receivership. This was the situation as set forth in the originally entered order in the case of Bernard Madoff. Additionally, in the recent case of *SEC v. Byers*,²⁷ the Second Circuit joined the Sixth and the Ninth Circuits that have held that the issuance of such an injunction can be a proper exercise of a federal judge's power. In *Byers*, the Second Circuit stated:

An anti-litigation injunction is simply one of the tools available to courts to help further the goals of the receivership. While such injunctions are to be used sparingly, there are situations in which they are entirely appropriate. In this litigation the receivership must manage hundreds of Wextrust entities that sprawl across the Middle East, Africa and the United States, many of which may have co-mingled assets. This is precisely the situation in which an anti-litigation injunction may assist the district court and receiver who will want to maintain maximum control over the assets. The current injunction prevents small groups of creditors from placing some entities into bankruptcy, thereby removing assets from the receivership estate to the potential detriment of all. We are persuaded that the powers afforded the receiver and the district court allow it to adequately protect the assets of the estate.

See also SEC v. Lincoln Thrift Ass'n, 577 F.2d 600, 604 fn. 4 (9th Cir. 1978) (because a stay was in effect, leave of court would have been required to file a bankruptcy petition).²⁸

In a different context, the Court of Appeals for the Fourth Circuit, in *Gilchrist v. General Electric Capital Corp.*, 262 F.3d 295 (4th Cir. 2001), expressed a different view. In *Gilchrist*, the federal district court appointed a receiver and issued an injunction directing that "all persons" take no action to affect the debtor's assets, but did not expressly prohibit the filing of an involuntary petition under the Bankruptcy Code. A week later, over fifty creditors of the debtor filed an involuntary bankruptcy petition against it. The district court held the petitioning creditors in contempt for violation of the injunction, and a feud then ensued between the district court and the bankruptcy court as to who had jurisdiction over the case, and whether continuation of the receivership action violated the automatic stay provision of 11 U.S.C. § 362. The Court of Appeals for the Fourth Circuit (without examining, but reserving, the question whether the bankruptcy had been properly filed) held that at a commencement of a bankruptcy case, the bankruptcy court, pursuant to 28 U.S.C. § 1334(e), had exclusive jurisdiction over the property of the estate as of the commencement of the case. *Id.* Therefore, the automatic stay provisions of 11 U.S.C. § 362 would prevent the district court judge from issuing its contempt order, unless there was an exception under Section 362 for such an order. The court also observed that the district court "provided no explanation of why, as a matter of equity, the bankruptcy process was not superior to a receivership in the liquidation of a large business, with assets in several jurisdictions and with thousands of creditors".²⁹ Accordingly, the Fourth Circuit remanded the case for actions in accordance with the opinion (including, it appears, the question of whether

²⁷ *SEC v. Byers*, 2010 WL 2366539, at *1 (2nd Cir. June 15, 2010).

²⁸ For a description of the opinion, see *Moore, Anti-Bankruptcy Injunctions: No Absolute Right to File an Involuntary Petition*, 29-7 ABIJ 48 (Sept. 2010).

²⁹ *Gilchrist v. General Electric Capital Corporation*, 262 F.3d 295, 303 (4th Cir. 2001).

Section 362 had an exception for the actions taken by the district court). Back at the district court, the reference to the bankruptcy court was removed, the bankruptcy case was transmitted to the receivership court, and the receivership court took over jurisdiction of the dual proceedings.³⁰ The court never returned to the specific remand and ultimately the receivership case was dismissed.

It bears noting that if the receivership had been pending for an extended period of time, or if other factors such as a direct prohibition of filing of involuntary bankruptcy proceedings had been in the *Gilchrist* order, the disposition of that case may have been different.

b. When The Receivership Order is Silent: Silence Is Golden . . . Or Is It?

On the other hand, a receivership order may be silent on the receiver's (or others') power to commence a bankruptcy proceeding. In such an instance and as recognized by the Honorable Judge Hale in *In re Statepark Building Group, Ltd.*,³¹ the receiver, as holder of the business's assets and as its sole management, is able to commence a bankruptcy proceeding³² without the approval of the court that created the receivership.³³

³⁰ *Gen. Elec. Cap. Corp. et al. v Spartan, et al.*, Civil number 7:01-cv -02316-MSB, U.S. District Court for the District of South Carolina, docket entry numbers 102 (Motion to Dismiss by General Electric Capital Corporation) and 103 (Order granting Motion).

³¹ *In re Statepark Building Group, Ltd., et. al*, Case No. 04-33916-hdh-11 (ruling that the state-court-appointed receiver had authority to commence a bankruptcy proceeding even though the receivership order did not expressly grant the receiver such authority).

³² As explained by the Supreme Court, "the initiation of the [bankruptcy] proceedings, like the run of corporate activities, is left to the corporation itself, i.e. to those who have the power of management." *Price v. Gurney*, 324 U.S. 100, 104, 65 S. Ct. 513, 515 (1945). It is the control over the management of the entity, as provided for under state law, that determines who has the authority to file a bankruptcy petition for the entity. See *id*; *In re Audubon Quartet Inc.*, 285 B.R. 250, 254 (Bankr. W.D. Va. 2002) (stating that "[t]he decision to initiate a bankruptcy case by a corporate entity must be made by those who have the power of management"); *Union Planters Nat'l Bank v. Hunters Horn Assocs. (In re Hunters Horn Assocs.)*, 158 B.R. 729, 730 (Bankr. M.D. Tenn. 1993) (stating that "the filing of a voluntary bankruptcy petition for a partnership is a management prerogative exercised by the entity or individuals having authority to act for the partnership"); *In re Monterey Equities-Hillside*, 73 B.R. 749, 752 (Bankr. N.D. Cal. 1987) (holding that state court receiver for limited partnership had authority to file a bankruptcy petition: "[a] bankruptcy petition for a partnership . . . may be filed by those who, under state law, have the authority to manage the entity"). Under Texas law, the appointment of a general receiver displaces and supersedes in its entirety the pre-receivership management of the entity. See *Murphy v. Argonaut Oil Co.*, 23 S.W. 2d 339, 342 (Tex. 1930) (finding that the president of an entity in receivership had no control or authority over the entity and that "[f]or all practical purposes, the authority of the officers of the corporation had been entirely superseded" by the receivership); *Salgo v. Matthews*, 497 S.W. 2d 620, 629 (Tex. Civ. App. – Dallas 1973, writ ref'd n.r.e.) (stating that "[t]he only person entitled to act for [corporation in receivership] was its receiver"). As a result and because a receiver manages the receivership entity and holds the entity's property, case law holds that a state court receiver has the authority to file a bankruptcy petition for the entity in receivership. See *Chitex Communications Inc. v Kramer*, 168 B.R. 587, 590 (S.D. Tex. 1994); *In re Gen-air Plumbing & Remodeling*, 208 B.R. 426, 431 (Bankr. N.D. Ill. 1997) (finding that state court receiver had the authority to file a bankruptcy petition).

³³ With respect to a state court receivership, the state court's authority is likely not required prior to the commencement of a bankruptcy proceeding. See *Central Mortgage & Trust Inc. v. State of Texas (In re Central Mortgage & Trust Inc.)*, 50 B.R. 1010, 1020 (S.D. Tex. 1985) (stating that "[i]t has long been held that a corporation may not be precluded by state law from availing itself of federal bankruptcy law."). *Accord Cash Currency*

Additionally, if a receiver or other authorized party places the entity that is the subject of the receivership into a bankruptcy proceeding, the receivership would essentially morph into the bankruptcy proceeding because, among other things, all of the receivership property becomes property of the estate pursuant to section 543 of the Bankruptcy Code.³⁴ To the extent that some but not all of the related entities in a receivership are placed into bankruptcy, a protocol that is unanimously agreed to by the affected parties might enable the parallel proceedings to co-exist despite the minefield of potential conflicts between the proceedings.³⁵ On the other hand, the bankruptcy proceedings of only some of the members of a corporate group could obscure the proper consolidation of enterprise-wide activities conducted through multiple entities, some of which are not in bankruptcy.

B. Participation Of Creditors In Receivership Proceeding And Of Equity Investors In Bankruptcy Proceedings

Under the priority scheme established by Congress as set forth in the Bankruptcy Code, creditors generally have priority in payment over distributions to equity investors in a bankruptcy proceeding. On the other hand, some receiverships do not necessarily place the interests of creditors over equity investors and, in fact, in certain receiverships, such as a receivership commenced at the request of the SEC, recoveries payable to creditors may be subordinated to recoveries payable to investors. As a result, the parties must understand their rights in a receivership. Conversely but equally true, because a bankruptcy proceeding places the interests of legitimate creditors over the interests of equity investors, those equity investors must understand their rights in a bankruptcy proceeding. Notably, in many bankruptcy proceedings, a multitude of parties-in-interest participate to some degree. This may not be case in receivership proceedings, particularly SEC-instigated receivership proceedings.³⁶

1. The Role Of Creditors In Receiverships

a. Intervening In A Receivership

In a bankruptcy proceeding any party-in-interest can typically be heard on any issue.³⁷ But it is not as straightforward in a receivership--a person (including a creditor) who wishes to

Exchange Inc. v. Shine (In re Cash Currency Exchange Inc.), 762 F.2d 542, 552 (7th Cir. 1985) (stating that “a corporation may not be precluded by state law from availing itself of federal bankruptcy law”).

³⁴ See 11 U.S.C. § 543(b) (stating that a “custodian [which section 101(11) defines as, among other things, a receiver] shall (1) deliver to the trustee any property of the debtor held or transferred to such custodian . . .”).

³⁵ Priority conflicts and conflicts regarding “claw back” proceeding in the receivership versus Chapter 5 proceedings in the bankruptcy proceeding are two of the many conflicts created by parallel proceedings that would likely have to be addressed by a protocol created to attempt to allow the parallel proceedings to co-exist.

³⁶ See *Gradwahl, Equity Receiverships for Ponzi Schemes*, 343 Seton Hall Legis. J. 181, 198 (2010) (“Although victims of securities fraud have been permitted, as a matter of right, to intervene in SEC enforcement actions, even where a receiver has been appointed, such intervention, whether permissive or as of right, is denied without prejudice by courts where a Ponzi scheme lies at the heart of the proceeding. . . The primary reason given by the court for such a denial was that there was an “unrebutted presumption” that the receiver and SEC adequately represented the interests of the victims’ interest.”)

³⁷ See 11 U.S.C. § 1109. This is not to say that the ability to file a pleading will give any party much voice, or that the party will not be bound by determinations in the case in which the party has not expressed its views.

become involved in a receivership must first persuade the court of its standing to be heard. In most cases, this can be accomplished through intervention.

i. Rule 24(a)(2) Of The Federal Rules Of Civil Procedure

In order to intervene in a receivership as a matter of right, a party must satisfy Rule 24(a)(2) of the Federal Rules of Civil Procedure, which requires the movant seeking to intervene to: (i) file a timely motion; (ii) demonstrate that it has an interest in the subject matter of the litigation; (iii) demonstrate that such interest will be impaired or impeded absent intervention; and (iv) demonstrate that the existing parties inadequately represent the movant's interests. Due to the requirements of Rule 24(a)(2) of the Federal Rules of Civil Procedure, and the understood role of the receiver in federal equity receiverships, intervention is typically an up-hill battle. Furthermore, allowing a party to intervene is typically the exception and not the rule.³⁸ Therefore, Rule 24(a)(2) of the Federal Rules of Civil Procedure can stand as a significant obstacle to a creditor or other party-in-interest that desires to become actively involved in a receivership if it cannot show that its interest is not otherwise adequately represented.

Of course, in certain cases and under certain circumstances, district courts have allowed creditors and other interested parties to intervene and/or be heard in a receivership in spite of the requirements of Rule 24(a)(2) of the Federal Rules of Civil Procedure. For example, court presiding over the *Stanford* receivership appointed an investors (or "victims") committee and created a mechanism for the receiver and that committee to present joint positions.³⁹ As noted, that was a proceeding in equity, and the court acted under its ability to control the case, rather than under the specific requirements of a statute or rule.

Furthermore, there has been some recognition for an interested person to be able to lodge an appeal (in particular, against a distribution plan) even though that person was not (and could not have been) a "party" in the underlying receivership proceeding.⁴⁰ This position illuminates the flexibility that courts managing receiverships seem to employ.

ii. A Bankruptcy Trustee's Ability To Intervene In A Receivership

In the seemingly rare situation in which a receivership continues after the commencement of a Chapter 7 bankruptcy proceeding, in addition to the requirement of Rule 24(a)(2) of the Federal Rules of Civil Procedure, a bankruptcy trustee must also establish that he has standing to be heard in the receivership. In general, a trustee's standing arises from the right to pursue property of the estate under sections 541(a) and 543 of the Bankruptcy Code. Such property of the estate includes causes of action held by the debtor when its bankruptcy case was commenced.

³⁸ See, e.g., *Gradwahl*, *supra*.

³⁹ *S.E.C. v. Stanford International Bank Limited, et al.*, U.S. District Court, Northern District of Texas, No. 3:09-CV-00298-N, document # 1149 (August 10, 2010). It may be notable that unlike an official committee in a bankruptcy proceeding, in this situation, the designated committee and its members were not allowed to charge their fees to the estate.

⁴⁰ *S.E.C. v. Basic Energy & Affiliated Resources, Inc.*, 273 F.3d 657 (6th Cir. 2001).

As a result, a bankruptcy trustee has standing to assert any of the debtor's causes of action.⁴¹ However, a bankruptcy trustee typically lacks standing to bring or intervene in a cause of action that belongs to a non-debtor third-party.⁴² Accordingly, a bankruptcy trustee's ability to intervene in a receivership is contingent on whether the subject matter of the receivership involves causes of action held by the debtor or causes of actions held solely by a third-party, such as an investor (equity or debt) or a other type of creditor of the Debtor.

2. The Role Of Equity Investors In Bankruptcy Proceedings

As a party-in-interest under section 1109 of the Bankruptcy Code, any investor can file pleadings and be heard in a Chapter 11 bankruptcy proceeding.⁴³ However, as a result of the priority scheme set forth in the Bankruptcy Code, equity investors' relative "power" in a bankruptcy proceeding is influenced by whether the estate has enough assets to satisfy the claims of all creditors. Simply put, if there is no money or other property for investors, then adequate representation of equity investors is not an issue because equity investors essentially have no interest in the bankruptcy proceeding to protect. Therefore, equity holders have an interest in seeking recharacterization or subordination of debt and in seeking the appointment of an equity committee. When it is clear that there is money or other property for the equity investors, then adequate representation of equity investors is a legitimate issue.

To that end, section 1102(a)(2) of the Bankruptcy Code allows the bankruptcy court to order the appointment of an official equity (or stockholders) committee if necessary to assure adequate representation of equity investors.⁴⁴ Although the appointment of an official equity committee is the exception rather than the rule,⁴⁵ the appointment of an official equity committee in a large and complex Chapter 11 case is not a rare event.⁴⁶ In fact, an official equity committee likely should be appointed in certain cases.⁴⁷

⁴¹ See *Schertz-Cibolo-Universal City, Indep. School Dis. v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1283-84 (5th Cir. 1994).

⁴² See, *Regan v. Vinick & Young (In re Rare Coin Galleries of America, Inc.)*, 862 F.2d 896, 900 (1st Cir. 1988) (stating that "[t]he trustee, however, has no power to assert any claim on behalf of the creditors when the cause of action belongs solely to them."); *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir. 1994); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979, 985 (11th Cir. 1990); *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988); *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222 (8th Cir. 1987); *Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*, 714 F.2d 1266 (5th Cir. 1983).

⁴³ This is not always the case under Chapter 7 liquidations under the Bankruptcy Code.

⁴⁴ That same section provides for committees for creditors, which can include non-equity investors, which charge their and their professionals' expenses to the estate.

⁴⁵ Courts generally rule that the appointment of an official equity committee is an extraordinary remedy, which should be the rare exception. See *In re Nat'l R.V. Holdings, Inc.*, 390 B.R. 690, 695 (Bankr. C.D. Cal. 2008), *In re Williams Commc'ns Grp., Inc.*, 281 B.R. 216, 223 (Bankr. S.D.N.Y. 2002).

⁴⁶ See, e.g., *In re Spectrum Brands*, Case No. 09-50455 (Bankr. W.D. Tex.); *In re Calpine Corp. Inc.*, Case No. 05-60200 (Bankr. S.D.N.Y.); *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y.); *In re Gadzooks, Inc.*, Case No. 04-31486 (Bankr. N.D. Tex.); *In re Mirant*, Case No. 03-46590 (Bankr. N.D. Tex.).

⁴⁷ Courts generally look to the following factors to determine whether appointing an official equity committee is a prudent decision: (i) whether the debtors are not hopelessly insolvent; (ii) whether the interests of equity holders are

The difference between the bankruptcy court appointing an official equity committee and a group of equity investors banding together to form an “ad hoc” committee centers around who picks up the tab for the committee’s expenses and its professionals’ fees. An official committee (and its professionals authorized by the court, including counsel, accountants, investment bankers and other professionals) are paid from the estate while an “ad hoc” committee may not be paid by the estate and, as a result, the committee member will have to foot the bill for their representation in the bankruptcy proceeding.⁴⁸ As a result, an official committee is typically more powerful than an “ad hoc” committee because an official committee’s representation will operate using assets of the estate while an “ad hoc” committee’s representation will likely be fueled only by the committee members’ pocket books.

II. CONCLUSION

For a variety of reasons, there is an increased likelihood of bankruptcy practitioners having to deal with receiverships in federal and state court proceedings that may impact a bankruptcy filing or an on-going proceeding. The implications and complications arising from a collision of these dual proceedings are potentially significant and an unarmed or unformed practitioner can be faced with serious challenges. However, as this article explains, there are reasonable tools at their disposal to address these potentialities and there are even recent case experiences that demonstrate that dueling proceedings can co-exist to the benefit of all constituencies.

being adequately represented; (iii) whether the costs of adequate representation of equity holders will not significantly outweigh the benefits; (iv) whether the case is large and complex; and (v) whether the debtor’s shares are widely held and actively traded. *See In re Williams Commc’ns Group, Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002); *In re Johns-Manville Corp.*, 68 B.R. 155 (S.D.N.Y. 1986); *In re Kalvar Micrfilm*, 195 B.R. 599 (Bankr. D. Del. 1996).

⁴⁸ An “ad hoc” committee may still be paid by the estate under certain circumstances. For example, the “ad hoc” committee could make a “substantial contribution” to the bankruptcy proceeding that could entitle it and its professionals to an administrative expense claim under section 503(b)(3)(D) and 503(b)(4) of the Bankruptcy Code.