



# Receivership Strategy When Risk is Long and Time is Short

By Michael Boudreau

## At a Glance

Lenders are faced with difficult circumstances when a borrower's business and the bank's collateral are deteriorating. When a lender is primarily concerned with protecting its collateral in a deteriorating situation, measuring alternative options can be considered relative to control, time, exposure, and cost.

Lenders are faced with difficult circumstances when a borrower's business and the bank's collateral are deteriorating. The downward spiral often includes declining or negative earnings, insufficient cash flow, declining enterprise value, escalating trade debt, and "tripped" financial covenants. Further, management has not been able to reverse these negative trends and, worse, have likely not been able to forecast these problems before they were reported. This will certainly erode trust between borrower and banker. When a lender is primarily concerned with protecting its collateral in a deteriorating situation, measuring alternative options can be considered relative to control, time, exposure, and cost.

Below is an overview of some common strategic options facing the lender.

### Voluntary Chapter 11 bankruptcy proceeding

In a voluntary Chapter 11 bankruptcy proceeding, the borrower typically maintains control as the debtor in possession, and timing is also driven by the borrower and its circumstances.<sup>1</sup> A Chapter 11 case is often expensive and paid from the lender's cash collateral. Professional fees often include the debtor's professionals and, depending on the case size, may also include an unsecured creditors' committee and its professionals (attorneys, financial advisors, etc.)<sup>2</sup> The lender will also be represented by legal counsel and financial advisors, and the U.S. Trustee Program, a component of the Department of Justice that oversees administration of bankruptcy cases and private trustees, is paid a quarterly fee based upon disbursements.<sup>3</sup> On the plus side, the lender gains additional visibility into the borrower's liquidity and puts limits on use of cash. From a timing perspective, bankruptcy doesn't have to be lengthy, but often marches down a long, winding road.

### Foreclosure

Foreclosure is often a less appealing option; the process can be time consuming and may or may not result in a buyer. Buyers will certainly discount offers based solely on the foreclosure process and will heavily discount value if they believe they are the only serious buyer. A major drawback to foreclosure in Michigan is the six-month redemption period following the sale during which the borrower/debtor remains in control of the property.<sup>4</sup> If a buyer doesn't materialize, the lender runs the risk of having to credit bid and take title to the property, which could also result in additional unwanted risks for the lender.

### Receivership

A receiver is an officer of the court focused on the management, protection, and operation of the business and property within the receivership.<sup>5</sup> Typically, a receiver protects the

interests of the creditors, shareholders, and all others claiming interest in the receivership's property. Courts have generally held that appointing a receiver does not alter ownership rights or change title to the property.<sup>6</sup> Rather, a receiver stands in the shoes of the person or persons whose assets are contained in the receivership.<sup>7</sup>

The powers of the receiver are typically identified in the order appointing the receiver, but they are generally not limited to:

- (1) obeying the orders of the court,
- (2) maintaining accurate business records,
- (3) preserving and protecting the receivership's property, and
- (4) operating or winding up the affairs of the business.<sup>8</sup>

As a practical matter, a recurring strategy should ultimately involve marshalling the assets, stabilizing the business, and expeditiously marketing and selling the assets for the highest value.

Receiverships offer lenders the opportunity to appoint a court-empowered neutral party to receive, preserve, and liquidate its collateral.<sup>9</sup> Special issues may arise within receiverships when the collateral is in multiple states or jurisdictions. Receivership actions are commonly filed in the state court in the county in which the debtor is located.<sup>10</sup> State court jurisdiction is confined to the state in which the court and property are located, while federal receivership actions are conducted in the federal district court and allow the receiver to exercise nationwide jurisdiction.<sup>11</sup> That said, seeking the appointment of a receiver in a federal court requires federal jurisdiction and a cause of action.<sup>12</sup> The motion to appoint a receiver is not by itself a cause of action, but ancillary to the complaint.

Receivership benefits include:

- **Control.** The party seeking the appointment (typically the secured lender) often nominates the receiver, subject to court approval. Conversely, in a Chapter 11 bankruptcy proceeding, ownership often remains in control as debtor in possession; in a Chapter 7 proceeding, the U.S. Trustee will appoint someone from its panel.<sup>13</sup>
- **Cost.** Compared to a bankruptcy proceeding, receivership is a lower-cost alternative with no U.S. Trustee quarterly fees or unsecured creditors' committee and its associated professional fees.<sup>14</sup> There are fees associated with the receiver and its counsel, but overall, they are much less than those in a bankruptcy.
- **Asset preservation.** Once appointed, a receiver quickly assumes day-to-day management and control of the bank accounts and assets.<sup>15</sup> Cash-flow planning is a critical starting point to understanding the current and projected liquidity and identifying needed changes to slow or eliminate cash shortfalls. Distressed assets are often

the result of mismanagement, fraud, theft, general misconduct, or a combination of those factors, which is why it's critical to initiate the receivership to preserve value.

- **Bankruptcy qualities with faster resolution.** The authority of a non-bankruptcy court can be used to accomplish the goals of the receivership.<sup>16</sup> For example, the receivership order typically includes a stay provision which mirrors the automatic stay in a bankruptcy. A well-crafted receivership order combined with an experienced receiver can guide the process to create the highest recovery values in a bankruptcy-like environment. The receiver may also choose to pursue legal claims belonging to the borrower to enhance creditor recoveries.<sup>17</sup>
- **Plan for success.** Selecting a receiver with both turnaround and industry experience is critical to a positive outcome. Turnaround experience is important because the situation will likely have liquidity and profitability issues; turnaround experience is necessary to stop the cash bleed to improve recoveries. This is extremely crucial for the lender — if there isn't enough cash flow to pay the operating costs and the receiver, the lender will almost always be required to fund the receivership. The turnaround professional also has the expertise to appropriately measure the progress, determine whether changes are working, and take necessary steps to address the variances to the plan. Further, the turnaround professional likely has experience in improving enterprise value and marketing the business for sale to generate numerous interested parties and guide the transaction to an expeditious close.

## Summary

Secured lenders wrestle with alternative choices when borrowers experience declining enterprise and collateral values. Time is typically short and, often, confidence in ownership and management to execute a turnaround or stop deterioration is low. In these circumstances, the margin for moving forward to repay the bank's credit is often slim to none. When the loan documents were signed, the lender held up its end of the bargain by funding the transaction, but the borrower has fallen short of its expectations, promises, and responsibilities. The time for action is now.

Under the right circumstances, placing the borrower's assets into a receivership can be an excellent vehicle to

maximize recoveries through a sale process, wind-down, or combination of the two. Receivership combines bankruptcy-like benefits with more control and less cost and shifts control to a court-appointed receiver (often suggested by the lender) who, in turn, reports to the court. The process is typically shorter than a bankruptcy and the secured lender is less exposed to potential successor liabilities associated with foreclosure while avoiding Michigan's six-month redemption period for a foreclosure sale.

Plan for success by identifying a receiver with both turnaround and industry experience. The turnaround professional has the skills to establish a plan, solve liquidity and cash-flow issues, and measure the plan to chart the next steps. The turnaround professional has experience marketing companies, identifying numerous potential buyers, and marching a sale process to a close. If winding down operations is the best path to recovery, the turnaround professional also has the expertise to maximize value in this arena. ■



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## ENDNOTES

1. 11 USC 1107.
2. 11 USC 327.
3. 11 USC 326.
4. MCL 600.3240.
5. MCL 554.1022.
6. 28 USC 3103.
7. 28 USC 3103.
8. MCL 554.1022.
9. MCL 554.1030.
10. MCL 554.1015.
11. 28 USC 3103.
12. 28 USC 960.
13. 28 USC 586 and 11 USC 101.
14. MCL 554.1031.
15. MCL 554.1022.
16. MCL 554.1024.
17. MCL 554.1022.