When Bankruptcy Collides with a Receivership or ABC

By Daniel C. Cohn[1]
Cohn Whitesell & Goldberg LLP
Boston, Massachusetts

In drafting the Bankruptcy Code, Congress clearly contemplated a scenario in which a bankruptcy case is commenced after an assignment for the benefit of creditors ("ABC") or the appointment of a receiver. This is best evidenced by Section 543, which dictates the turnover of property held by the receiver or assignee. In addition, Section 303(h)(2) provides that an ABC or appointment of a receiver in certain circumstances will provide grounds for entry of an order for relief after an involuntary petition is filed. Despite these provisions, the Code leaves largely unaddressed the issues that arise when a bankruptcy case is preceded by an ABC or receivership.

These materials will examine four such issues: (1) Does appointment of a receiver wrest from the board of directors (or other governing body) the power to cause the corporation (or other juridical entity) to file a bankruptcy petition? (2) Regardless of whether the board or other governing body has been stripped of this power, may the receiver file a bankruptcy petition on behalf of the entity? (3) When a receivership is

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superseded by a bankruptcy, may the receiver exercise the powers of a Chapter 11 debtor in possession, or be named as bankruptcy trustee? (4) When will the bankruptcy courts abstain from exercising jurisdiction over an entity that is the subject of a receivership or ABC?

I. Corporate Authority to File Bankruptcy Following Appointment of Receiver

A. State Receiverships

As a general rule, a state court's appointment of a receiver will not disrupt the ability of a corporate debtor, acting with the appropriate corporate consent, to file a voluntary petition. *See, e.g., Cash Currency Exch., Inc. v. Shine (In re Cash Currency Exch. Inc.)*, 762 F.2d 542, 552 (7th Cir. 1985); *In re Prudence Co., Inc.*, 79 F.2d 77, 80 (2d Cir. 1935); *Struthers Furnace Co. v. Grant*, 30 F.2d 576, 577 (6th Cir. 1929); *In re Corporate and Leisure Event Prod., Inc.*, 351 B.R. 724 (Bankr. D. Ariz. 2006); *Larson v. Kreisers, Inc. (In re Kreisers, Inc.)*, 112 B.R. 996, 1000 (Bankr. D.S.D. 1990); *In re S & S Liquor Mart, Inc.*, 52 B.R. 226, 227-28 (Bankr. D.R.I. 1985); *In re Greater Atlanta Apartment Hunter's Guide, Inc.*, 40 B.R. 29, 31 (Bankr. N.D. Ga. 1984); *In re Donaldson Ford, Inc.*, 19 B.R. 425 (Bankr. N.D. Ohio 1982). The courts reach this conclusion on the basis that "a corporation may not be precluded by state law from availing itself of federal bankruptcy law." *Cash Currency Exch.*, 762 F.2d at 552.

While the general rule is that state law or state courts cannot bar the bankruptcy courthouse door, confusion arises from a somewhat contradictory rule, enunciated in the Supreme Court's decision in *Price v. Gurney*, that an artificial entity's authority to act is determined as a matter of state law. 324 U.S. 100, 106 (1945). The conflict arises because state law often dictates that, once a receiver is appointed, the directors and

officers no longer have the ability to authorize actions of the corporation, like a bankruptcy filing. This issue was left unaddressed by the Supreme Court in *Price*. In that case, the Court dismissed a petition under Chapter X of the Bankruptcy Act filed by a shareholder of a corporate debtor that had been operated by a receiver appointed by an Ohio state court. The debtor corporation had, for a number of years, been controlled by the company's bondholders through a voting trust administered by a bondholders' committee. After an action was brought to foreclose the bondholders' lien, the state court appointed one of the voting trustees as a receiver. In order to forestall the foreclosure, a shareholder filed a Chapter X petition in the name of the corporate debtor along with an affidavit stating that he had unsuccessfully attempted to have the corporation file the petition. *Id.* at 101-02. The district court subsequently granted the bondholders' committee's and the corporation's motions to dismiss the petition. The appeals court reversed. *Id.* at 103. The Supreme Court reversed the appellate court and held that the district court must dismiss the case if it determines that the individuals who purported to act on behalf of the corporation were without authority to do so under applicable state law. *Id.* at 106 ("In the absence of federal incorporation, intracorporate disputes of the character presented here are...governed by state law.")

Since the bondholders in *Price* exercised control over the board of directors and the court-appointed receiver, the court did not need to decide which of the two had the authority to put the company into bankruptcy. Though the decision strongly implies throughout that the board, had it been so inclined, could have filed the petition despite the appointment of the receiver, it also indicates that "local law" dictates whether or not the bankruptcy court (or, in that case, district court) must dismiss the case. *Id.*

One court invoked *Price's* "local law" rule in dismissing a voluntary Chapter 11 filed after a receivership on the basis that, under applicable state law, the receiver supplanted the functions of the company's managers and officers. *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426, 430-31 (Bankr. N.D. Ill. 1997). In *Gen-Air*, two of the three directors of the corporate debtor had sought and obtained the appointment of a receiver to liquidate the debtor and resolve the deadlock that had arisen between the two directors (who together were also 50 percent shareholders) and a third director (who was the other 50 percent shareholder). Unhappy with the result in state court, the third director filed a Chapter 11 petition without the consent of the full board, purportedly on behalf of the corporate debtor. The first two directors filed a motion to dismiss the petition as an unauthorized filing. *Id.* at 428-29. The court stated that the authority to file a petition on behalf of a corporation derives from state corporate governance law and that, in Illinois, such authority resides with the board of directors. *Id.* at 430 (collecting cases). Noting that a single director was without authority under applicable state law to file the petition, the court held that the case should be dismissed on the basis that the filing was *ultra vires*. *Id.*

While *Gen-Air*'s initial holding was more than adequate for disposal of the case, the court elected to provide an additional basis for dismissal: "Moreover, Illinois law provides that when a receiver is appointed, the functions of the corporation's managers and officers are suspended and the receiver stands in their place." *Id.* The court acknowledged that courts in other jurisdictions have held that the appointment of a receiver did not deprive directors of the ability to file a corporate petition, but then held that the "better and proper view" is the application of Illinois law, *i.e.*, suspension of the

directors' corporate authority. *Id.* at 431.[2] In holding that the appointment of a state court receiver removes the authority from corporate boards to file a petition, *Gen-Air* directly conflicts with the majority of cases cited *supra* p. 1.

The Southern District of Texas supplies another case that applies *Price* to hold that the appointment of receiver overrides the normal corporate authorization process. *Chitex Communication, Inc. v. Kramer*, 168 B.R. 587 (S.D. Tex. 1994). In *Chitex* the court held, in part, that under Texas law the corporate debtor could not be put in bankruptcy by a stockholder after a receiver had been appointed. *Id.* at 590. The case arose out of a divorce proceeding in which a state court issued a divorce decree declaring that the debtor corporation was a marital asset, and appointing a receiver to take ownership of the stock (and all voting rights) in the corporation. After the appointment of the receiver, the husband filed a Chapter 11 petition on behalf of the corporation, based on his purported authority as company president and corporate counsel. The case was subsequently dismissed by the bankruptcy court, and the husband appealed. *Id.* at 588-89. On appeal, the district court held, citing *Price*, that the husband lacked authority to file a petition on behalf of the corporation and that the receiver had full rights to control the company. Though the divorce decree did not remove the husband as an officer or director, the court stated that "it is axiomatic that a decree that vests 100% ownership and all rights of management of a closely held corporation in a receiver constitutes a de facto removal of [the husband] from any position of authority." *Id.* at 589-90.

[2] The court did not address the holding in *Cash Currency Exchange supra* p. 2, which seems to provide controlling Seventh Circuit authority to the contrary.

The most obvious distinction between *Chitex* and the normal receivership scenario is that the receiver had an ownership interest in the stock of the debtor corporation itself, and not merely control of the debtor corporation's property. However, the court seemed to make no distinction between the facts of that case and a more typical receivership – instead stating that, as a matter of Texas law, the "president of an insolvent corporation had no authority to affect the corporation's property interests once a state court had placed it into receivership..." and "Texas law asserts that the receiver has the full rights that the corporation had." *Id.* at 590 (citing Texas cases). The court in *Chitex* did not address or attempt to distinguish the majority view that a state court may not preclude a bankruptcy filing by the duly appointed corporate board (though it could easily have done so on the facts before it).

While it would be tempting to dismiss *Gen-Air* and *Chitex* as being distinguishable based on the fact that one involved little more than an intracorporate dispute that the bankruptcy court was correct to avoid, and another a divorce case in which the receiver controlled the stock of the debtor/marital asset, to do so would be to disregard the sweeping holdings of each case expressly stating that a state court receivership removes authority from a corporation's management to file bankruptcy. However, no other reported decisions have adopted the holdings of *Gen-Air* or *Chitex* to dismiss a bankruptcy case, so the clear weight of authority upholds the right of a corporation to file bankruptcy despite a state court receivership.[3]

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[3] *Chitex* has been cited in support of a holding that a receiver has authority to file a petition on behalf of an entity. *See In re StatePark Building Group, Ltd.*, 316 B.R. 466, 471 (Bankr. N.D. Tex. 2004) (discussed *infra* Part II). Also, in refusing to dismiss the case before it, one court attempted to distinguish *Gen-Air* on the basis that it "appeared" to concern "a purely intracorporate dispute (rather than a dispute with creditors) as to who has the authority to file..." *In re Corporate and Leisure Event Prod., Inc.*, 351 B.R. 724, 730-31, n. 22 (Bankr. D. Ariz. 2006). While the *Corporate Leisure* court's observation that Gen-Air was really an intracorporate dispute was correct, the *Gen-Air* court did not stop with its initial holding (that the 50%

B. Federal Receiverships

When a receiver has been appointed by a *federal* court, the picture is not so clear. In *United States v. Royal Bus. Funds Corp.*, 724 F.2d 12, 15-16 (2d Cir. 1983), the Second Circuit upheld the district court's stay of a pending Chapter 11 where the district court had previously appointed a receiver pursuant to an action brought by the Small Business Administration (the "SBA") under the authority granted by the Small Business Investment Program (15 U.S.C. §§ 661-697).[4] While the Second Circuit made clear it did not intend to disturb the general rules (1) that an equitable receivership will not preclude a bankruptcy petition or (2) that equity receiverships should not perform the functions of the bankruptcy court, it held that a debtor subject to a federal receivership has no absolute right to file a bankruptcy. *Id.* The court held that the debtor in that case had waived its ability to file a bankruptcy petition (absent authority from the district court) because: (1) there were no significant creditors other than the SBA, (2) the debtor had consented to the receivership, (3) by its consent, the debtor had obtained more than $3.5 million in fresh funds from the SBA, and (4) the receiver had been operating the debtor for more than a year. *Id.*

Since the debtor in *Royal Business* obtained $3.5 million from the SBA in exchange for its acquiescence to a receivership, it would be easy to dismiss the case as an outlier based on the court's apparent reliance in rendering its decision on the equities at

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shareholder lacked authority to file a petition without board consent), but went on to hold (not couched as *dictum*) by holding that the receiver supplanted the board's authority as a matter of state law. One Northern District of Illinois bankruptcy court has expressly rejected *Gen-Air*, though it too characterized the alternative holding in Gen-Air as dictum: ". . . to the extent the *Gen-Air* decision contains dicta suggesting that a state receivership might prevent a board of directors from filing a bankruptcy petition (without any reference to [*Cash Currency Exchange*]), it is neither persuasive nor controlling." *In re Auto. Prof'ls, Inc.*, 370 B.R. 161, 181 (Bankr. N.D. Ill. 2007), *aff'd*, 379 B.R. 746, 757 (N.D. Ill. 2007).

[4] 15 U.S.C. § 687c(b) provides that the district court may take exclusive jurisdiction of the assets of a small business investment licensee and appoint a trustee or receiver to administer such licensee's assets.

play. However, in another SBA case that also concerned a receiver appointed pursuant to 15 U.S.C. § 687c(b), the court found that a bankruptcy petition filed after entry of a temporary restraining order and appointment of a temporary receiver was a nullity. *United States v. Vanguard Inv. Co., Inc.*, 667 F. Supp. 257, 259 (M.D.N.C. 1987), *aff'd*, 907 F.2d 439, 440 (4th Cir. 1990). In holding that the debtor should have sought permission from the district court before filing its petition, the court noted the holding in *Royal Business Funds* and ruled that the facts in its case also compelled a similar result. *Vanguard*, 667 F. Supp. at 260-61. Among the factors the court considered were: (1) the district court had exclusive jurisdiction under 15 U.S.C. § 687c(b),[5] (2) the SBA's case had elements of a regulatory enforcement action, and (3) the SBA was the debtor's primary creditor and there were no significant private creditors. *Id.*

While none of these factors are likely to come into play in the context of the standard equity receivership, the court's basic holding that the debtor was not entitled as a matter of right to file a bankruptcy petition, coupled with the same holding in *Royal Business Funds*, create an apparent duty on debtors and their counsel to seek leave from the district court to file a bankruptcy petition once a federal receiver has been appointed. Moreover, aside from the above factors, which are seemingly exclusive to the SBA/enforcement context, the *Vanguard* court also stated that the interests of creditors other than the SBA would be protected in a receivership by the oversight of the district court, and that the decision to reorganize under Chapter 11 versus liquidate in a receivership was not one that should be made until the receiver had an opportunity to

[5] The district court in *Royal Business Funds* had based its decision on this factor alone. *United States v. Royal Bus. Funds Corp.*, 29 B.R. 777, 779-80 (S.D.N.Y. 1983). In upholding the decision, the Second Circuit did not address this issue.

make its report and recommendation.[6] *Id.* at 261. Of course, both of these concerns are applicable in every equity receivership and can only serve to inject further uncertainty concerning a company's ability to file a petition.

To the extent there is a distinction between federal and state receiverships, it almost certainly turns on the source of the "right" to file bankruptcy. *Vanguard* and *Royal Business Funds* are not inconsistent with those decisions that couch this right in terms of the Constitution's supremacy clause. *Larson v. Kreisers, Inc. (In re Kreisers, Inc.)*, 112 B.R. 996, 998 (Bankr. D.S.D. 1990) (citing supremacy clause); *Jordan v. Indep. Energy Corp.*, 446 F.Supp. 516, 525 (N.D. Tex. 1978) (noting that supremacy clause might provide basis for disparate results in cases rendered under the Bankruptcy Act). *See also Cash Currency Exch., Inc. v. Shine (In re Cash Currency Exch. Inc.)*, 762 F.2d 542, 552 (7th Cir. 1985) (holding that *state* receivership will not preclude bankruptcy filing); *In re Corporate and Leisure Event Prod., Inc.*, 351 B.R. 724, 728 (Bankr. D. Ariz. 2006) (same); *In re S & S Liquor Mart, Inc.*, 52 B.R. 226, 227 (Bankr. D.R.I. 1985) (same). However, at least one bankruptcy court since 1978 has stated that the ability to file bankruptcy is a right that may not be enjoined by *either* state or federal courts. *In re Donaldson Ford, Inc.*, 19 B.R. 425, 430 (Bankr. N.D. Ohio 1982) (collecting cases under the Bankruptcy Act). In addition, one district court held that, while a federal court could theoretically restrain voluntary or involuntary bankruptcies through a blanket receivership injunction, such an action would never satisfy the requisite test for a preliminary injunction because of the irreparable harm it would inflict on the debtor and its creditors, and because it could never be in the public interest, as it would

[6] In addition, the court seemed to put the burden on the debtor to demonstrate that a bankruptcy will be more fair and efficient to itself and its creditors than a receivership. *Vanguard*, 667 F. Supp. at 261.

be in direct contravention of the Congressional intent evidenced in the establishment of the Bankruptcy Act. *Jordan*, 446 F.Supp. at 529-30 (lifting receivership injunction and enabling pending bankruptcy case to proceed). While *Jordan*, which was not addressed in *Royal Business Funds* or *Vanguard*, permits the filing of a bankruptcy petition after entry of a federal receivership injunction, the holding still requires that the debtor or petitioning creditors seek leave from the district court before the bankruptcy case may proceed (even though it provides that such permission must always be granted).[7] In light of these cases, a company subject to a federal receivership is well advised to seek leave from the district court before it files a petition.

II. Can a Receiver File Bankruptcy?

While the general rule is that, after the appointment of a receiver by a state court, the corporate board retains the authority to file bankruptcy on behalf of a corporate debtor, courts do not reach the converse result (that the receiver lacks such authority) with similar consistency. In one instance, a court suggested that a receiver could not file a bankruptcy petition. *In re Prudence Co., Inc.*, 79 F.2d 77, 80 (2d Cir. 1935). That pre-Code decision was based largely on a non-sequitur: the court's observation that the receiver could not possess the power to put the debtor in bankruptcy since the bankruptcy would necessarily terminate the receiver's stewardship of the debtor's assets.[8] However,

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[7] Counsel to debtors could subject themselves to potential sanctions for filing a bankruptcy petition without court authority even if they have a good faith belief that the debtor has a right to file bankruptcy. *Jolly v. Pittore*, 170 B.R. 793, 798 (S.D.N.Y. 1994).

[8] In 1938 (shortly after *Prudence*), Congress amended the Bankruptcy Act to codify the turnover of the debtor's property (former Section 2a(21)). 5 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 543.LH. (15th ed. 2008). Former Section 2a(21) is similar to the current statute. 11 U.S.C. § 543. Section 543, "Turnover of property by a custodian," provides, in pertinent part:

> (a) A custodian with knowledge of the commencement of a case under this title concerning the debtor may not make any disbursement from, or take any action in the administration of, property of the debtor, proceeds, product, offspring, rents, or profits of such property, or property of the estate, in the

the receiver's obligation to turn over the debtor's property to the trustee or debtor in possession once a bankruptcy case is commenced should not necessarily bear on whether the receiver can initiate the bankruptcy case in the first instance upon determining that a bankruptcy would be in the debtor's best interest – for example, in order to obtain the Bankruptcy Code's avoidance powers for the benefit of the debtor's creditors.[9]

A bankruptcy court questioning whether a receiver has the power to file on behalf of a corporation declined to dismiss a case on that basis. *See In re Milestone Ed. Inst., Inc.*, 167 B.R. 716 (Bankr. D. Mass. 1994). The court in *Milestone*, where the receiver had obtained express authority from the state court to file a bankruptcy petition, observed that there are two fundamental principles at play under federal law: (1) the authority to file bankruptcy depends on the corporate documents and state law, and (2) the appointment of a receiver does not dispossess the directors of the power to file a petition. *Id.* at 720. The court also observed that, just because the directors retain the requisite authority, it does not necessarily follow that a state court cannot authorize a receiver to file a petition; but then the court also noted that the scant authority on the topic does not provide "unequivocal support for the proposition that a receiver may commence a voluntary petition with the authority of the state court." *Id.* at 722.

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possession, custody, or control of such custodian, except such action as is necessary to preserve such property.

(b) A custodian shall--

(1) deliver to the trustee any property of the debtor held by or transferred to such custodian, or proceeds, product, offspring, rents, or profits of such property, that is in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case; and

(2) file an accounting of any property of the debtor, or proceeds, product, offspring, rents, or profits of such property, that, at any time, came into the possession, custody, or control of such custodian.

[9] Subsequent decisions from the Second Circuit have apparently ignored this language in *Prudence*. *See In re Manhattan Inv. Fund., Ltd.*, 310 B.R. 500, 503 (Bankr. S.D.N.Y. 2003) (describing without comment procedural history in which receiver appointed by federal district court filed Chapter 11 petition and was appointed Chapter 11 trustee).

Ultimately, the court held (1) though the receiver possessed many of the powers of management, he was not a substitute director and was not the corporation, and (2) the filing of the petition must have the effect of terminating the receivership. *Id.* at 723. Moreover, the bankruptcy court stated that the state court's endorsement of the receiver's bankruptcy petition was without precedent and observed that, in so ordering, the state court had created the prospect of oversight by two different courts, since the state court's order did not explicitly terminate the receivership. *Id.*[10] Rather than dismiss the case outright, the bankruptcy court granted relief from stay so a creditor opposing the bankruptcy filing could pursue its appeal in the state court for a determination whether, as a matter of state law: (1) a state court receiver can commence a bankruptcy case absent a vote of the directors, and, if so, (2) whether a receiver can be invested with authority to act in the bankruptcy case such that "it is clear that the corporation not the receivership is the debtor..." *Id.* at 724. While any determination of these two questions on appeal is unreported, implicit in the bankruptcy court's holding is that, as a matter of federal law, the bankruptcy court should accept a case filed by a receiver who has the power and authority to do so under state law.

In other cases, each of which concerned a limited partnership as debtor, the courts have found that the receiver had the power to initiate a bankruptcy case. *In re StatePark Building Group, Ltd.*, 316 B.R. 466 (Bankr. N.D. Tex. 2004); *In re Monterey Equities-Hillside*, 73 B.R. 749 (Bankr. N.D. Cal. 1987). In *Monterey Equities-Hillside* the state court appointed a receiver at the request of certain limited partners (after the general partner informed the limited partners it did not intend to take action to prevent a

[10] The bankruptcy court noted, however, that "[f]ederal preemption compels the conclusion that the receivership must yield..." *Id.* at 723.

scheduled foreclosure sale). The receivership order expressly authorized the receiver to file Chapter 11, which he did by filing a voluntary petition. *Monterey Equities-Hillside*, 73 B.R. at 751. Citing, *inter alia*, *Price v. Gurney supra* p. 2 (the Supreme Court decision holding that state law governs the authority of an artificial entity to act) for the proposition that a petition may be filed by whoever has management authority under state law, and noting that the receiver was expressly authorized to file a petition by the state court, the bankruptcy court denied the general partner's motion to dismiss the case.[11] The court noted that, while the general partner had cited several cases that held that a corporate board of directors retained authority to file, those cases did not suggest that the receiver was divested of such power. *Id.* at 752.

The court in *StatePark Building Group* reached a similar conclusion. There, several limited partnerships were dissolved and a receiver was appointed. After six months, the receiver filed Chapter 11 petitions seeking to liquidate the partnerships in bankruptcy. 316 B.R. at 469. The bankruptcy court denied motions to dismiss the Chapter 11 cases, holding that, as a matter of Texas law, the receiver had authority to file the petitions on behalf of the partnerships. *Id.* at 470-71.[12]

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[11] Technically, the receiver's petition was an involuntary one. The court concluded that Fed. R. Bankr. P. 1004(a), as then in effect, required that all general partners consent to the filing of a voluntary petition, but that the receiver could commence an involuntary case as a "general partner" under Section 303(b)(3)(A). *Monterey Equities-Hillside*, 73 B.R. at 752. Rule 1004(a) has since been abrogated by the 2002 amendments, so applicable non-bankruptcy law now provides the basis for determining the requisite authority for a partnership's voluntary petition. 9 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 1004.02 (15th ed. 2008).

[12] In some respects, this result is unsurprising given that, in support of its decision, the court cited the decision in *Chitex Communications*, which, as described *supra* Part I, is one of only a handful of bankruptcy court decisions that can be read to deny a corporate board the authority to file a bankruptcy petition once a state receiver is appointed. *In re StatePark Building Group, Ltd.*, 316 B.R. at 471.

III. Receiver as Debtor in Possession

Imbedded in the second question the *Milestone* decision reserved for the state court (and seemingly ignored in *StatePark* and *Monterey Equities*) was: once it is established that the bankruptcy court has jurisdiction over a corporate debtor subject to a receivership, can it authorize the receiver to act as a DIP, or have him or her appointed as a trustee? Section 543(d) of the Bankruptcy Code (which authorizes the court to excuse a receiver or assignee from the turnover requirements in the other subsections of 543 if the court determines that to do so is in the interest of creditors) could be construed to provide a basis for vesting the receiver with the powers of a debtor in possession – particularly where the debtor's management is unwilling or unable to operate the debtor. However, cases that have examined the issue have refused to provide such a broad reading to Section 543(d). For instance, where the debtor's principal filed a petition immediately after the appointment of a receiver, and promptly sought a turnover of property from the receiver, the court issued, but ultimately backed away from, an interim order excusing the receiver from the turnover requirements and vesting the receiver with the powers of a DIP. *In re Plantation Inn Partners*, 142 B.R. 561, 562 (Bankr. S.D. Ga. 1992). When the U.S. Trustee filed a motion for the appointment of a Chapter 11 trustee, the court considered whether a receiver excused from turnover pursuant to Section 543(d) could proceed indefinitely as a substitute DIP. *Id.* Observing that 11 U.S.C. § 105(b) expressly prohibits the appointment of a receiver by a bankruptcy court, the court held that it could avail itself of the services of a state court receiver for only a limited period of time – essentially, until it makes a final determination of whether the court will abstain from the

case altogether, appoint a trustee, or return control of the debtor to its original management. *Id.* at 564-65.[13]

In cases where a receiver files a chapter 11 petition on behalf of a corporate debtor, the receiver is sometimes appointed trustee by the bankruptcy court, but some courts remain generally unwilling to allow the receiver *qua* receiver to function as a debtor in possession. *Compare In re Stratesec, Inc.*, 324 B.R. 158 (Bankr. D.D.C. 2004) (construing Sections 105(b) and 543(d) and ordering appointment of trustee other than receiver following Chapter 11 petition filed by receiver), *with In re Iowa Trust*, 135 B.R. 615, 624 (Bankr. N.D. Iowa 1992) (dismissing Chapter 7 filed by debtor, but noting that state appointed receiver could re-file in different venue as Chapter 11 debtor in possession), *and In re Uno Broadcasting Corp.*, 167 B.R. 189, 201 (Bankr. D. Ariz. 1994) (leaving status of receiver "to another day").

A potential strategy for avoiding the displacement of a receiver after the filing of a bankruptcy petition is to have the person appointed as both receiver and the debtor's new management. This was what happened in *In re Bayou Group, L.L.C.*, where the company's original management had pled guilty to various charges stemming from a massive Ponzi scheme perpetrated through the debtor entities. *Adams v. Marwil (In re Bayou Group, L.L.C.)*, 363 B.R. 674 (S.D.N.Y 2007). Pre-bankruptcy, an unofficial creditors' committee was organized and requested that the federal district court appoint someone to act as both receiver and "exclusive managing member" of the debtors. *Id.* at 676. On notice to all known creditors and without objection, the requested relief was

[13] Though courts may be reluctant to have the receiver act as the DIP in a case, section 543(d) does contemplate keeping the receiver in place in certain cases, even though "basic equities would favor a debtor in possession having access to all its assets while attempting to reorganize." *In re Falconridge, LLC*, 2007 WL 3332769, at *6 (Bankr. N.D. Ill. 2007) (allowing receiver appointed at request of under-secured lender to continue to administer debtor's apartment building postpetition).

granted based on, *inter alia*, federal securities laws and the district court's inherent equitable powers. The appointee then filed Chapter 11 petitions for each of the debtors, which he executed as the managing member, not as receiver. *Id.* at 678-80. In accordance with the district court's order, the appointee's role as receiver terminated upon the bankruptcy filings. The appointee filed with the bankruptcy court a notice of compliance with section 543, whereby the appointee *qua* receiver purported to deliver the debtors' property to the debtors-in-possession. *Id.* at 681. The United States Trustee moved for appointment of a Chapter 11 trustee on the grounds that section 543(b) required actual turnover of the debtors' property to a third party because the appointee remained a "custodian" due to his role as a receiver, and that his appointment as exclusive managing member was derivative of his role as receiver. *Id.* at 683. After the bankruptcy court denied the UST's motion, the district court affirmed (the same district court that appointed the receiver/managing member in the first instance) on the basis that the appointee had not merely been designated as the receiver, but also as the debtors' replacement corporate management. *Id.* at 684.

The holding in *Bayou Group* provides a potential strategy for parties in interest to designate a person who will both be able to function with the powers of a receiver pre-bankruptcy, and as a debtor-in-possession postpetition. Ultimately, the issue will be whether or not the debtor's situation justifies appointment of a person as both receiver and replacement management for the juridical entity. The court in *Bayou Group* acknowledged that its holding "contradicts the spirit—albeit not the letter of the 1978 Bankruptcy Reform Act . . . " since the unofficial creditors' committee had "found a way to appoint their own bankruptcy 'trustee,' by having a district judge do it prior to any

filing in bankruptcy." *Id.* 689-90. However, the court justified this result on the basis that the circumstances in that case—incapacity of the debtors' original management due to their being charged criminally—were not likely to be a frequent occurrence. *Id.* at 690.

IV. Abstention

Even if a petition is deemed properly filed – whether by the debtor, receiver or assignee – courts will frequently consider whether they ought to abstain under 11 U.S.C. § 305(a)(1).[14] Though abstention is often described as "the exception rather than the rule," and as requiring a fact-specific inquiry, *In re Iowa Trust*, 135 B.R. 615, 621 (Bankr. N.D. Iowa 1992), the pendency of a receivership or an ABC provides frequent fodder for Section 305(a)(1) motions. Many courts have cited to Section 305's legislative history, which references out-of-court alternatives to bankruptcy, as evidence that the pendency of a non-federal insolvency proceeding should be considered in determining whether abstention is appropriate.[15] *See, e.g., In re Short Hills Caterers, Inc.*, 2008 WL 2357860, at *5 (Bankr. D.N.J. 2008); *In re Cincinnati Gear Co.*, 304 B.R. 784, 785

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[14] Section 305(a)(1) provides:

> (a) The court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if--
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> > (1) the interests of creditors and the debtor would be better served by such dismissal or suspension...

A decision by the bankruptcy court on a motion brought under Section 305(a)(1) may not be appealed. 11 U.S.C. §305(c); *In re Cash Currency Exchange, Inc.*, 762 F.2d 542, 555-56 (7th Cir. 1985).

[15] The legislative history states:

> The court may dismiss or suspend under the first paragraph, for example, if an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the results of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment. The less expensive out-of-court workout may better serve the interests in the case.

S. REP. NO. 95-989, at 36 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5822.

(Bankr. S.D. Ohio 2003); *In re Iowa Trust*, 135 B.R. at 621-22; *In re M. Egan Co., Inc.*, 24 B.R. 189, 191 (Bankr. W.D.N.Y. 1982).

A. Abstention Following an Involuntary Petition

Though dismissal under Section 305(a)(1) is always a fact specific inquiry, abstention is not uncommon in cases involving an involuntary petition coming on the heels of an ABC. *See, e.g., In re Bailey's Beauticians Supply Co.*, 671 F.2d 1063 (7th Cir. 1982) (construing the Bankruptcy Act in light of enactment of Section 305); *In re Short Hills Caterers, Inc.*, 2008 WL 2357860 (Bankr. D.N.J. 2008); *In re Cincinnati Gear Co.*, 304 B.R. 784 (Bankr. S.D. Ohio 2003); *In re Artist's Outlet, Inc.*, 25 B.R. 231 (Bankr. D. Mass. 1982); *In re M. Egan Co., Inc.*, 24 B.R. at 189. Efficiency and the avoidance of duplication are frequently cited as a basis for abstention in these cases. *In re Short Hills Caterers, Inc.*, 2008 WL 2357860, at *5; *In re Bailey's Beauticians Supply Co.*, 671 F.2d at 1067; *In re Artist's Outlet, Inc.*, 25 B.R. at 233; *In re M. Egan Co., Inc.*, 24 B.R. at 192. However, courts will elect to retain an involuntary case filed after an ABC if it believes doing so will be in the interest of creditors. *See In re John Oliver Co., Inc.*, 24 B.R. 539 (Bankr. D. Mass. 1982) (finding that continuation of bankruptcy case is in the interest of creditors where preference recovery could be obtained only in bankruptcy).

In cases where an involuntary petition is filed after a receivership, courts will likewise abstain in the interest of efficiency and reduced cost. *In re Williamsburg Suites, Ltd.*, 117 B.R. 216, 220 (Bank. E.D. Va. 1990); *In re Michael S. Starbuck, Inc.*, 14 B.R. 134, 135 (Bankr. S.D.N.Y. 1981); *In re Sun World Broadcasters, Inc.*, 5 B.R. 719, 722 (Bankr. M.D. Fla. 1980). A bankruptcy court will also abstain from an involuntary case

if it believes the petition was, in reality, an attempt by a disgruntled creditor to appeal an adverse result in the state receivership. *In re Sun World Broadcasters, Inc.*, 5 B.R. at 722-23. Abstention is also likely where the debtor has no prospect of reorganization, and it appears that creditors will fare the same in a receivership liquidation as they would in bankruptcy. *In re Prop. Mgmt. & Inv., Inc.*, 19 B.R. 202, 203-04 (Bankr. M.D. Fla. 1982). The chances of abstention also increase if the receivership has been pending for an extended period of time, and the receiver has made substantial progress in administering the debtor's assets. *See In re Onyx Records, Inc.*, 42 B.R. 156 (Bankr. S.D.N.Y. 1984) (abstaining where receivership had been pending 7 years); *In re Sun World Broadcasters, Inc.*, 5 B.R. 719, 722 (same, pending 4 years). As with a case filed after an ABC, a bankruptcy court is more likely to retain a case where doing so would preserve an avoidance action not available at state law. *See In re Barker-Chadsey Co.*, 28 B.R. 308, 310 (Bankr. D.R.I. 1983). Courts have split on whether distributions pursuant to a state liquidation must track the Bankruptcy Code's priority scheme before a bankruptcy court will abstain. *Compare In re Sun World Broadcasters, Inc.*, 5 B.R. at 722 (abstaining and finding that principles and federalism do not require that every state court liquidation follow the priorities of 11 U.S.C. § 726) *with In re Barker-Chadsey Co.*, 28 B.R. at 310 (citing availability of additional wage claim priority in bankruptcy as factor in declining abstention).

B. Abstention following a Voluntary Petition

As with involuntary cases, courts will consider efficiency and potential duplication when deciding whether to abstain following a voluntary petition.[16] *Compare*

[16] In an early case under the Bankruptcy Code, one court implied abstention could never be appropriate in a voluntary case since Section 305 requires a finding that abstention is in the debtor's interest and it "defies

In re Iowa Trust, 135 B.R. 615, 623 (Bankr. N.D. Iowa 1992) (holding that efficiency and economy of administration would be best served by abstention), *and In re O'Neil Village Personal Care Corp.*, 88 B.R. 76, 80 (Bankr. W.D. Pa. 1988) (abstaining and noting risk of duplication of efforts by trustee if case remained with bankruptcy court), *with In re Uno Broadcasting Corp.*, 167 B.R. 189, 199 (Bankr. D. Ariz. 1994) (declining to abstain where receiver had yet to take any steps in adjudicating claims), *and In re Donaldson Ford, Inc.*, 19 B.R. 425, 434 (Bankr. N.D. Ohio 1982) (declining abstention where receiver had only been appointed for three days). However, efficiency concerns alone are often deemed an insufficient basis for abstention when the debtor seeks to reorganize (rather than liquidate) in bankruptcy or when the liquidation would be facilitated by a provision of the Bankruptcy Code. *See Cent. Mortgage & Trust, Inc. v. Texas (In re Cent. Mortgage & Trust, Inc.)*, 50 B.R. 1010, 1021 (S.D. Tex. 1985) ("The interest of the debtor in attempting a reorganization outweighs any competing considerations of efficiency and economy that may exist."); *In re StatePark Building Group, Ltd.*, 316 B.R. 466, 477 (Bankr. N.D. Tex. 2004) (declining abstention so that receiver could proceed in bankruptcy and sell assets free and clear).

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credulity to say that the debtor's interest would be better served by a dismissal when the debtor voluntarily sought" Chapter 11. *In re Donaldson Ford, Inc.*, 19 B.R. 425, 435 (Bankr. N.D. Ohio 1982).