

SEC Receivers v. Bankruptcy Trustees:

Liquidation by Instinct or Rule

Written by:

Marcus F. Salitore

Jackson Walker LLP; Dallas, Texas

msalitore@jw.com

Civil complaints filed by the Division of Enforcement of the Securities and Exchange Commission (SEC) often seek relief ancillary to the injunctive relief for which the federal securities laws expressly provide. One form of ancillary relief is the appointment of a receiver to assume control of the assets of the subject party (usually, but not necessarily, a business entity). In many such cases, the receiver marshals the assets and eventually liquidates the defendant. The use of a federal equity receivership to effect a liquidation introduces a host of complex and unsettled issues. This discussion will summarize the powers of a federal equity receiver with a focus on the SEC receivership, and highlight inconsistencies and conflicts between the administration of an estate under the Bankruptcy Code and a federal liquidating receivership. Lastly, this analysis will examine possible origins of the problems affecting liquidating receiverships and suggest solutions for practitioners and courts faced with a potential receivership liquidation.

The SEC acts “as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws.” *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975). On a proper showing by the SEC of a securities violation, a district court in an enforcement

action has the authority to fashion virtually any appropriate remedy. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1973). An appropriate remedy may include disgorgement, restitution and rescission. *Id.* at 1100-1106. Thus, the SEC comes to court armed with significant influence. To preserve such remedies the court may also impose an asset freeze combined with other injunctive relief. *SEC v. Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990). Each of the Securities Act of 1933 and the Exchange Act of 1934 expressly grant the district courts the power to issue injunctive relief. It has become common, however, for the SEC to seek relief ancillary to the injunction, often requesting the appointment of a receiver. Goodenow, Gary L., *Litigating the SEC's Ancillary Enforcement Remedies Following Central Bank and its Progeny*, 21 Am. J. Trial Advoc. 67, 67 (Summer 1997).

Courts view the appointment of a receiver as a drastic remedy. *Id.* Federal judges will, however, appoint a receiver at the SEC's request when necessary to preserve the status quo or to prevent diversion or waste of assets. *SEC v. Current Financial Services, Inc.*, 783 F.Supp. 1441, 1443 (D. D.C. 1992)(the court may appoint a receiver in an SEC enforcement action at the request of the SEC if necessary to effectuate the purposes of the federal securities law). Courts grant such ancillary relief using their inherent equitable powers. *Manor Nursing Centers, Inc.*, 458 F.2d at 1105. The scope of a receiver's authority is established by the granting court on a case-by-case basis. *See id.* Indeed, the Ninth Circuit Court of Appeals provides that the "district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is *extremely broad . . .*" *SEC v. Hardy*, 803 F.2d 1034, 1037-38 (9th Cir. 1986)(emphasis added). Thus, the parameters of the receiver's powers are dictated solely by the federal district court granting the receivership.

The federal district court's appointment of a receiver may be appealed immediately under 28 U.S.C. § 1292 which, in pertinent part, provides "the courts of appeals shall have jurisdiction of appeals from . . . [i]nterlocutory orders appointing receivers, or refusing orders to wind up receiverships or to take steps to accomplish the purposes thereof, such as directing sales or other disposals of property." 11 U.S.C. § 1292(a)(2); *see also SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80 (2d Cir. 2001)(finding the district court's order approving receiver's proposed settlement plan providing for distribution of assets subject to appeal because district court's ruling was a modification of the initial asset freeze and appellate review extends to all matters inextricably bound to the preliminary injunction). The federal district court's appointment of a receiver may only be overturned, however, for an abuse of discretion. *SEC v. Spence & Green Chemical Co.*, 612 F.2d 896, 904 (5th Cir. 1980). The decision to remove a receiver is, like the decision to appoint one, an equitable determination resting in the discretion of the district court. *Id.* A receivership once imposed should be terminated as soon as the reason for its imposition has ceased. *Id.*

When a receivership that begins for the purpose of merely holding or marshaling assets winds into liquidation, the procedure and safeguards of the Bankruptcy Code and its legislated schemes of distribution and priority are often not be honored. *See, e.g., SEC v. TLC Investments and Trade Co.*, 147 F.Supp.2d 1031, 1034 (9th Cir. 2001)(specifically rejecting a request that the court order the receiver to administer the estate as a trustee would administer an estate in bankruptcy, following all the procedures of the Bankruptcy Code). A liquidating receiver may, for example, propose the use of a plan for distribution of assets but fail to incorporate the absolute priority concept central to bankruptcy law. More specifically, in a liquidating receivership born out of an SEC

enforcement action, the receiver may focus on protection and recovery of assets for the purpose of compensating defrauded securities investors and afford such investors a priority in distribution. This result might even be prompted by the receiver's interest in future appointments from the SEC because the receiver knows the SEC's focus is on protecting those persons who are the victims of securities fraud. In a liquidation effected under the Bankruptcy Code, defrauded investors are treated on the same priority as general unsecured creditors.

Also, the receiver or the federal district court may not be equipped, experienced or prepared for the administration of a complex liquidation. *SEC v. American Board of Trade*, 830 F.2d 431, 436-38 (2d Cir. 1987). The receiver appointed at the request of the SEC might be more experienced in securities law than the Bankruptcy Code. Receivers often selectively choose to apply individual Bankruptcy Code concepts resulting in a "cafeteria" format in which the rights of all parties might be compromised. *See American Board of Trade*, 830 F.2d at 434 (liquidating receivership criticized for selective application of bankruptcy concepts). Bankruptcy Code provisions are interrelated and do not function well in isolation. Further, because liquidating receivers frequently adopt procedures only as the need arises, the entire liquidation and distribution process often teeters close to the edge of due process abuse. *See TLC Investments and Trade Co.*, 147 F.Supp.2d at 1034 (9th Cir. 2001)(liquidating receivership procedures challenged on due process grounds but ultimately affirmed).

American Board of Trade, provides an example of a liquidating receiver adopting piecemeal many Bankruptcy Code concepts. 830 F.2d at 436-438. In that case, the district court adopted the following measures on the receiver's recommendation: (a) customers and creditors were required to

file by a date certain a statement with the receiver establishing their claims; (b) after the bar date, the receiver was to create certain reserve accounts for disputed priority claims and use the remaining assets to make an interim *pro rata* distribution to the general creditors; (c) the receiver was empowered to close under-performing facilities, surrender the leases and liquidate the personalty thereon; and (d) the receiver was required to distribute to creditors a report that summarized the receiver's proposed final distribution and priority scheme and provided for a period of time within which creditors could submit comments to the court before a hearing at which the receiver's recommendation would be considered and all interested parties could participate. *Id.* at 438. In the consolidated appeal challenging the receivership, the circuit court observed, "the district court essentially transformed itself into a court of bankruptcy aided by a receiver performing the tasks of a bankruptcy trustee." *Id.* at 438-39.

Ultimately, the circuit court in *American Board of Trade* affirmed the district court's appointment of the receiver because the liquidation was nearly completed. The circuit court noted, however, that the district courts do not possess the resources or experience of the bankruptcy courts relating to the liquidation of a company. *Id.* at 438. The circuit court suggested that federal receivership liquidation process should not be used as a substitute for bankruptcy. *Id.* Perhaps most significantly, the circuit court provided, "We now state, however, that in actions of the present kind brought in the future by the SEC, we expect counsel for the agency, as an officer of the court and as part of his or her professional responsibility, to bring our views, as stated in this and other decisions, to the attention of the district court before the court embarks on a liquidation through an equity receivership." *Id.* Thus, the Second Circuit, at least, has clearly recognized the limitations of a federal liquidating receivership.

The origin of many problems affecting liquidating receiverships relates to (a) the nature of the receivership as a form of relief, and (b) the timing of the decision to liquidate. First, the nature of receivership relief often creates the “creeping receivership.” Considering SEC receiverships specifically, SEC enforcement actions typically involve fraud and other wrongdoing demanding quick, sometimes *ex parte*, action to preserve assets. The need for quick action poses a dilemma for the federal court given that appointment of a receiver is a drastic remedy. Courts confronted with such a dilemma often initially appoint a receiver with limited powers and narrowly defined objectives, such as conducting an inventory or accounting. *SEC v. American Board of Trade*, 830 F.2d at 434. Courts should only permit a receiver to assume total control of the defendant after more limited relief has failed. *Id.* The district courts’ tendency toward incremental increases in the receiver’s power creates the “creeping receivership.”

The creeping receivership directly impacts the timing of the decision to liquidate. Often, by the time the decision to liquidate is made, economy of administration appears to support a process of letting the receiver complete the liquidation rather than commencing a bankruptcy case. The situation may be further aggravated by a receiver’s motive to retain control of the case. Many cases offer direct criticism of liquidations effected through federal receivers. *See e.g. SEC v. S&P National Corp.*, 360 F.2d 741, 750-51 (2d Cir. 1966); *Lankenau v. Coggenshall & Hicks*, 350 F.2d 61, 63 (2d Cir. 1965); *Esbitt v. Dutch-American Mercantile Corp.*, 335 F.2d 141, 142 (2d Cir. 1964). Few courts, however, have opted to remove a receiver at the liquidation stage. *See American Board of Trade*, 830 F.2d at 437 (observing, “we have never vacated or modified a receivership order on the ground that a district court improperly attempted to effect a liquidation”). Indeed, most

liquidating receivers survive challenge on appeal simply because by the time the receiver's appointment or liquidation is challenged the process has evolved too far. *See id.*

The federal receiver, therefore, becomes a liquidator without the supporting structure of the Bankruptcy Code, Rules and precedent. The procedure for liquidation becomes *ad hoc* employing "equity" as the only guideline. As we know, not all parties agree as to what constitutes equitable treatment. The creeping receivership and late liquidating decision cause unpredictable, disorganized and haphazard receivership liquidations with procedures constructed and developed only as needed at the potential expense of creditors or other parties. In contrast, the Bankruptcy Code provides a complete, coordinated and integrated mechanism for orderly liquidation.

Presuming liquidations effected through the Bankruptcy Code are preferable to receivership liquidations and recognizing the dilemma faced by the district courts considering receiver appointment, the solution might lie in early recognition of the need for liquidation by both the supervising district court and the parties in interest. In addition, district courts should attempt to avoid the creeping receivership by questioning at the outset the probable result of the federal receivership. After appointment, the supervising court should closely and frequently scrutinize the receiver's progress and construct a reporting mechanism for the court and creditors to provide transparency. Practitioners representing creditors of parties subject to a federal receivership should continuously evaluate the potential for liquidation and, if necessary, act quickly to urge the commencement of a bankruptcy case. At the very least, the practitioner should closely monitor the case for any attempt by the receiver to seek authority to dissolve or liquidate the company. Recall, the appointing court defines the receiver's powers and, therefore, must grant the receiver the

authority to liquidate. *Id.* at 436. Early recognition of potential liquidation cases will enable all parties to steer these cases to the bankruptcy courts where administration under the Bankruptcy Code is more likely to provide a more equitable and efficient result.