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A tale of two orders

It was the best of times, it was the worst of times. You obtained a valid, final, state court order appointing a receiver under the Illinois Mortgage Foreclosure Law (IMFL) and the receiver has been preserving and protecting the parcel of real estate in question for months.

The receiver has made repairs to the property, the receiver has collected rents, the receiver has obtained the turnover of all of the borrower's books and records and the receiver has made regular reports to the Illinois state court. Things were good — or at least as good as they could have been in that situation.

Now the borrower files for bankruptcy, obtains an order for relief and directs the receiver to immediately cease all of its work. Does the bankruptcy filing trump the order appointing the receiver? Does it automatically overturn the order appointing the receiver? Does the receiver need to immediately surrender all of the books, records and (perhaps most alarmingly to lenders) rents collected?

While the answer I give my lender clients is "not necessarily," it is worth understanding why a receiver may not be required to stop all of his or her work and surrender the books, records, rents, etc., simply upon the filing of a bankruptcy case.

Section 543(a) of the Bankruptcy Code is crystal clear that once the receiver is made aware of the borrower's bankruptcy filing that receiver may not make any disbursements of the debtor's property or take any action in the administration of the debtor's property.

Section 543(b) of the Bankruptcy Code is equally clear that the receiver "shall" turn over any of the debtor's property to the debtor and file an accounting as to any property that has, at any time, come through the receivership. But Section 543(d) of the Bankruptcy Code is really where receivers and the lenders who had them appointed want to concentrate their time and attention.

Section 543(d)(1) excuses a receiver from compliance with Section 543(a) and (b), after notice and a hearing, "if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a [receiver] to continue in possession, custody or control of such property."

In other words, if the debtor is insolvent, the bankruptcy court may excuse the turnover of the debtor's books, records, rents and other property if the interests of creditors would be better served by allowing the receiver to remain in possession and control.

Only if the debtor is solvent can the bankruptcy court also take into consideration the interests of the debtor's owners. Consequently, just because the borrower has filed a bankruptcy case does not necessarily mean that all of the receiver's hard work was for naught.

However, in order to be successful on a motion to excuse compliance with Section 543(b) under Section 543(d)(1), the movant must establish, by a mere preponderance of the evidence, that the interests of creditors are "better served" by allowing the receiver to remain in possession and control.

While a number of factors may be looked at in determining how the interests of those creditors may be "better served," U.S. Bankruptcy Judge Jacqueline P. Cox of the Northern District of Illinois enumerated some of the more relevant factors that will be considered in *In re Falconbridge LLC*, 2007 WL 3332769 (Bankr.N.D.Ill. 2007).

DECODING THE CODE

WILLIAM S. HACKNEY

William S. Hackney is a member of SmithAmundsen's financial services group, concentrating his practice in the area of bankruptcy, corporate reorganization and creditors' rights. He has experience representing debtors, lenders, secured creditors, creditors' committees and trustees, among others, in all manners of Chapter 11 and Chapter 7 cases as well as out-of-court workouts and restructurings. He also acts as outside bankruptcy counsel to corporations and provides general business counseling in distressed situations.

Cox opined that the seven most relevant factors included: (1) the likelihood of reorganization; (2) the probability that funds required for reorganization will be available; (3) whether there are instances of mismanagement by the debtor; (4) whether turnover would be injurious to creditors; (5) whether the debtor will use the turned over property for the benefit of creditors; (6) whether or not there are avoidance issues raised with respect to property retained by a receiver because a receiver does not possess avoiding powers for the benefit of the estate; and (7) the fact that the bankruptcy automatic stay has deactivated the state court receivership action.

More recently, U.S. Bankruptcy Judge Jack B. Schmetterer, also of the Northern District of Illinois, narrowed his list of most relevant factors in determining whether the creditors' best interests would be served by excusing compliance to the following four factors: (1) the likelihood of reorganization and whether funds held by the receiver are required for reorganization; (2) whether there are instances of mismanagement by the debtor; (3) whether turnover would be injurious to creditors; and (4) whether the debtor will use the turned over property for the benefit of creditors. See *In re Franklin*, 476 B.R. 545, 551 (Bankr. N.D.Ill. 2012).

Both Cox in *Falconbridge* and Schmetterer in *Franklin* ended up excusing the state court receiver's compliance under 543(d)(1) using these factors. As might be expected, considerable attention was paid by both judges to instances of mismanagement by the debtor. While neither *Falconbridge* nor *Franklin* mention it specifically, receivers and lenders may want to pay particular attention to the issues of rent diversion and failure to pay real estate taxes.

Both seem to be common occurrences in the types of cases I am seeing and both can be hot button issues with bankruptcy judges looking to protect the interests of creditors.

So, while the filing of a bankruptcy case by a debtor is an extremely powerful tool to stop an ongoing state court receivership and repossess both control of the property at issue and any rents collected thereunder, it by no means spells the end of the line for a lender seeking to prevent further injury to its collateral.

The bankruptcy code does provide a mechanism by which a receiver need not surrender possession or control of the property under its supervision; the receiver just needs to be vigilant in its usage of that mechanism.

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