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A Model Statute for Free-and-clear Sales by Equity Receivers

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A great deal of equity receivership law is based on the common law, and cases on key issues in equity receiverships often are not uniformly decided.[1] Because bankruptcy/insolvency practitioners expect resurgence in the use of receiverships in the coming years, it may behoove us to codify important common law practices and achieve some predictability of procedure and substance in equity receivership cases in state courts.

For example, is a receiver entitled to sell receivership property free and clear of liens without the consent of all lienholders? We believe the answer is yes—with important due process caveats (and notwithstanding some case law to the contrary). This article offers a three-part test to help judges and lawyers determine whether such a sale is warranted, as well as a model statute for the consideration of legislators, judges and lawyers.

This article proceeds in five parts, with this first part serving as an introduction. In Part II, we briefly summarize the history of receiverships and offer reasons why resurgence in receiverships may be expected. Part III sets forth an objective lesson on the need for some uniformity of procedure and substance in receivership sales: The split of Ohio's appellate courts on whether a receiver may sell free and clear of liens where a lienholder objects to such a sale.[2]

In Part IV, we recommend that courts reaffirm receivers' broad powers to act in the best interest of *the receivership property*. We have also submitted for discussion a model statute that authorizes receivers to sell receivership property free and clear of all liens over the objection of a lien creditor, so long as this three-part test is met: First, all lien parties should receive "enhanced notice" of the sale and the opportunity to be heard or, where appropriate, ordinary notice of the sale and the opportunity to be heard; second, if there is an objection to the sale, the receiver should offer evidence that the sale is "commercially reasonable"; and lastly, the net proceeds from the receiver's sale should attach to the existing liens proportionately and according to pre-sale priority. Part V is the conclusion.

Feature

Background of the Law of Receivers

Henry Clark's seminal treatise, *Clark on Receivers*, provides a comprehensive history of receiverships from the time of the Norman Conquest.[3] The law of receivers evolved in England's courts of equity, Chancery Courts.[4]

Receiverships were not broadly used in American courts until great industrialists of the 19th Century sought to take control of insolvent railroads. Railroads suffered from a malaise known to many chapter 11 debtors: valuable assets and no operating cash.[5] Thus, late 19th Century American courts utilized equity receiverships from the common law, the remedy that became the historical antecedent to modern chapter 11 bankruptcy. Courts devised the model of equity receiverships as a way to reorganize insolvent railroads by adjusting the rights of all creditors under one unified proceeding.

In the landmark case of *Macon & Western Railroad v. Parker*,[6] the Georgia Supreme Court placed an insolvent railroad into the hands of a court-appointed trustee. The court of equity created an estate that consisted of all of the assets of the railroad. The railroad brought its own motion to enjoin execution by judgment creditors. By bringing the entire property before

1 See 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); Prof. David A. Skeel Jr., "The New (and Very Old) State Law Technique for Restructuring Troubled Companies," American Bankruptcy Institute online (2006), available at www.abiworld.org (click "search" and type in "very old").

2 See Quill v. Troutman Enterprises, 2005 Ohio App. LEXIS 1976, 2005 WL 994676, 2005-Ohio-2020 (2d Dist.); ODOT v. Eastlake Land Development Co., 894 N.E.2d 1255, 2008-Ohio-3013 (8th Dist. Ct. App.). See infra Background of the Law of Receivers.

3 Henry Clark, Clark On Receivers, Ch. I, §§1–10.

4 See Jeffrey Stern, "Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique," 90 Colum. L. Rev. 783, 793 (1990) ("[b]y longstanding rule, a single court of equity, either upon a creditor's bill for general liquidation or, in some cases, at the request of the executor, could take control of a decedent's estate and adjust the various claims against it, staying all other actions.").

5 Stephen J. Lubben, "Railroad Receiverships and Modern Bankruptcy Theory," 89 Cornell L. Rev. 1420, 1441 (2004).

6 Macon & W.R.R. v. Parker, 9 Ga. 377 (1851).

the court, the railroad obviated the need for disparate proceedings.[7]

Congress's introduction of federal bankruptcy legislation, the Bankruptcy Act of 1898, did not slow down the use of receiverships. First, that act did not permit the reorganization of large corporations and exempted railroads from its coverage altogether.[8] Second, there was less need for a federal solution to insolvency when most commerce was *intra*state. Thus, receiverships continued to be widely used until the mid-1930s, when Congress added corporate reorganization provisions to the Bankruptcy Act, "essentially codifying receivership practice for corporations."[9]

Modern Resurgence

Four factors have led to a surge in the use of receiverships. First, rooted as they are in equity, receivers may be granted powers that are broader and more flexible than those available under the Bankruptcy Code. *In SEC v. Hardy*, the Ninth Circuit identified a basic advantage of receiverships: The district court's inherent power in supervising an equitable receivership and determining appropriate action in its administration is extremely broad.[10]

For example, in *SEC v. Black*, the Third Circuit held that where a receiver is properly before it, the district court has wide discretion as to how to proceed.[11] *In SEC v. Safety Finance Service*, the Fifth Circuit held that a court sitting in equity has wide discretionary powers when charged with overseeing a receivership.[12] And in *SEC v. Wencke*, the Ninth Circuit held that "federal courts have inherent equitable authority to issue a variety of 'ancillary relief' measures in actions brought by the SEC...."[13]

The second reason for the current growth in the use of receiverships is that courts may use summary remedies to allow, disallow and subordinate the claims of creditors.[14] *In U.S. v. Arizona Fuels Corp.*, the Ninth Circuit held that allowing a single receivership proceeding to resolve all claims "advance the government's interest in judicial efficiency by reducing the time needed to resolve disputes, decreasing the costs of litigation, and preventing the dissipation of the receiver's assets."[15] *SEC v. Basic Energy*. However, the Sixth Circuit cautioned that in exercising equitable discretion, courts must provide claimants with due process.[16]

The third reason for increased interest in receiverships was created by a recent decision that has rocked the bankruptcy community: *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*.[17] In that case, the Ninth Circuit Bankruptcy Appellate Panel (BAP) reversed the trial court's approval of a §363 sale by holding that a senior secured creditor's credit bid, in an amount less than the aggregate value of all liens against the property in question, did not satisfy the requirements of §363(f). The court found that the sale under §363 was not "free and clear" of the existing junior liens on the property and that those liens survived the sale.[18] What good is a §363 sale if the liens are not shed?

Finally, the weak economy, foreclosure volume, the crises in the stock markets and "credit crunch" have resulted in "underwater" properties; *i.e.*, properties encumbered by liens and mortgages that exceed their value. Creditors are resorting to receiverships as a more cost-effective way to liquidate collateral than chapter 11 bankruptcies, which are often large, expensive undertakings.

Case Law Precedent for Selling Property Free and Clear of Liens

Significant authority exists that "a court may order the sale of equity receivership property free and clear of liens and encumbrances under the appropriate circumstances."[19] In *Mellen v. Moline Malleable Iron Works*, the U.S. Supreme Court stated that "the removal of alleged liens or incumbrances upon property, the closing up of affairs of insolvent corporations, and the administration and distribution of trust funds, are subjects over which courts of equity have general jurisdiction."[20] Following *Mellen*, courts have used their equitable powers to allow receivers and trustees to sell free and clear of liens in many instances.[21]

In one recent example, the U.S. District Court for the District of Massachusetts recognized a court's implied power to sell assets free and clear of creditors' claims in a private sale made after notice and an opportunity to be heard.[22] In contrast to *Callahan*, in *J.E. Akers Co. v. Advertising Unltd.*, the Kansas Supreme Court reversed the district court's authorization of a receiver's sale free and clear of liens, even though creditors were given proper notice and a hearing.[23] The court held that such sales may only take place if there is a genuine dispute as to the liens' validity. Since the receiver did not provide sufficient evidence to create such a dispute, the sale was improper.[24] Confusion exists on the issue of if a receiver's sale may be made free and clear of liens.

The split in Ohio's appellate courts presents a case study for this issue. In the cases that follow, it is clear that the power to sell free and clear of liens can only be exercised when the rights of lien creditors to notice, hearing and a commercially reasonable sale are respected. In other words, in receivers' sales, due process rights of all lienholders are entitled to great deference.

Ohio Appellate Law on Receivers' Sales Free and Clear of Liens

In State ex rel. Celebrezze v. Gibbs, the Ohio Supreme Court stated that Ohio Revised Code §2735.04 "enable[d] the trial court to exercise its sound judicial discretion to limit or expand a receiver's

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7 Id. at 393–94; Stern, supra n. 6.

8 See id. at 791.

9 See Skeel, supra n. 3.

10 SEC v. Hardy, 803 F.2d 1034, 1038 (9th Cir. 1986). See also SEC v. Credit Bancorp Ltd., 290 F.3d 80, 87 (2d Cir. 2002) (a court may make equitable distributions of assets to fraud victims of a "Ponzi scheme"); SEC v. United Fin. Group Inc., 474 F.2d 354, 358–59 (9th Cir. 1973) ("The district court has broad powers and wide discretion to frame the scope of appropriate equitable relief."). See generally Wright & Miller, 16 Fed Prac. & Prod. Juris. 2d §3925 ("[a] receivership can drastically curtail existing property rights").

11 See SEC v. Black, 163 F.3d 188, 199 (3d Cir. 1998).

12 See SEC v. Safety Fin. Service, 674 F.2d 368, 372–73 (5th Cir. 1982).

13 SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980).

14 See SEC v. Basic Energy & Affiliated Res. Inc., 273 F.3d 657, 668 (6th Cir. 2001) ("This discretion, which 'derives from the inherent powers of an equity court to fashion relief,' makes the use of abbreviated, summary processes possible."); SEC v. Elliott, 953 F.2d 1560 (11th Cir. 1992) (noting that summary proceedings reduce time necessary to settle disputes, decrease litigation costs, and prevent further dissipation of receivership assets); Wencke, supra n. 17 at 837 ("The use of such proceedings enables a receiver to...avoid formalities that would slow down the resolution of disputes. This promotes judicial efficiency and reduces litigation costs to the receivership.").

15 See SEC v. Basic Energy & Affiliated Res. Inc., 273 F.3d 657, 668 (6th Cir. 2001); United States v. Arizona Fuels Corp., 739 F.2d 455, 458 (9th Cir. 1994). See also Hardy, supra n. 10 at 1040 ("[T]he use of summary proceedings to determine appropriate relief in equity receiverships...is within the jurisdictional authority of a district court...The procedures used...were a reasonable and practicable attempt to administer the receivership without depriving the creditors of fair notice and a reasonable opportunity to respond.").

16 SEC v. Basic Energy & Affiliated Resources, 273 F.3d 657, 668 (6th Cir. 2001).

17 Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC), 391 B.R. 25 (B.A.P. 9th Cir. 2008).

18 Id. at 39.

19 Abney, supra n. 3. See also "Annotation, Power of Court to Authorize or Direct Receiver (or Trustee in Bankruptcy) to Sell Property Free from Liens," 35 A.L.R. 255 (1925); updated by 78 A.L.R. 458 (1932) and 120 A.L.R. 921 (1939, cases updated through 2008); 16 W. M. Fletcher, Fletcher Cyclopedia of the Law of Private Corps. §7878 (2005); 65 Am. Jur. 2d Receivers §343 (2005).

20 Mellen v. Moline, 131 U.S. 352, 367 (1889).

21 See, e.g., Broadway Trust Co. v. Dill, 17 F.2d 486 (3d Cir. 1927) (authorizing sale of insolvent company's land free of liens upon notice to all parties); Van Huffel v. Harkelrode, 284 U.S. 225, 227 (1931) (allowing trustee to sell free and clear under federal bankruptcy law); DeAngelis v. Newman, 350 Pa.Super. 536, 504 A.2d 1279 (1986) (action for specific performance of an agreement to sell land where Superior Court recognized court's authority to order a sale of land free of encumbrances). See also Abney, supra n. 3 at fn. 3 (collecting cases).

22 John T. Callahan & Sons Inc. v. Dykeman Elec. Co. Inc., 266 F.Supp.2d 208 (D. Mass. 2003).

23 J.E. Akers Co. v. Adver. Unlimited, 49 P.3d 506 (Kan. 2002).

24 Id. at 509–10.

powers as it deems appropriate. Absent a showing that the trial court has abused that discretion, a reviewing court will not disturb the trial court's judgment."[25] Over half a century previously, the Ohio Supreme Court held that a receiver, as an officer of the court, has full power to do all things necessary while acting in the capacity in which he was appointed.[26] Other sections of the Ohio Revised Code (such as §§1707.27 and 1701.90) contain no restrictions on what the court may authorize regarding receivership property.[27]

Au v. Au Rustproofing[28]

Au Rustproofing was the first case in which an Ohio court examined a receiver's ability to sell property free and clear of liens. The first lienholder on the property at issue argued that the trial court wrongly approved the receiver's proposed sale. The Fifth District Court of Appeals agreed with the first lienholder and held that the trial court erred in allowing a receiver's sale that would take away lien rights in property that were vested by contract, absent consent of the lienholder.[29]

Quill v. Troutman Enterprises[30]

Twenty-one years after *Au Rustproofing*, Ohio's Second District Court of Appeals decided *Quill v. Troutman Enterprises*. The court expanded trial courts' powers to authorize a receiver to sell property free and clear of liens, even where an interested party protests the sale.[31] Significant to the court's analysis in *Quill* was that the complaining creditor had notice that the receiver was appointed, the property was being sold for more than it would yield at a foreclosure sale and the creditor had notice that the property was to be sold free and clear of liens.[32] The creditor was given notice and several opportunities to object to the sale. Finding his eventual objection to be untimely, the trial court upheld the sale. The appellate court affirmed, holding that Ohio's general receivership statute "does not contain *any* restriction on what the court may authorize when it issues orders regarding receivership property."[33]

[25] State ex rel. Celebrezze v. Gibbs, 573 N.E.2d 62, 68–69 (Ohio 1991).
[26] Toot v. Beech, 1 N.E.2d 940, 942 (Ohio 1936).
[27] See, e.g., Ohio Rev. Code §1707.27; Ohio Rev. Code §1701.90 (LexisNexis 2006). The Ohio Rev. Code contains more than 75 statutes that refer to receivers.
[28] Au v. Au Rustproofing, 1984 Ohio App. LEXIS 10561, 1984 WL 4959 (5th Dist.).
[29] Id. at *1.
[30] Quill v. Troutman Enterprises, 2005 Ohio App. LEXIS 1976, 2005 WL 994676, 2005-Ohio-2020 (2d Dist.).
[31] Id. at **16–17.
[32] Id. at *41.
[33] Id. at *34 (emphasis added).

Ohio Dept. of Transportation v. Eastlake Land Development Co.[34]

On June 23, 2008, Ohio's Eighth Appellate District Court in *Eastlake* reversed a trial judge's authorization of a receiver's sale of property free and clear of liens. The facts of *Eastlake* indicate, however, that important due process rights of lien creditors may have been trampled in the sale process.

In *Eastlake*, the trial court appointed a receiver in March 2003 in a foreclosure action filed by the State of Ohio as first mortgagee of parcels that were owned by Eastlake Land Development. In February 2007, the receiver proposed to sell a parcel free and clear of liens with the consent of the State of Ohio. American First Federal (AFF), a third-party lienholder, objected, but there was no evidentiary hearing on the proposed sale of property. The receiver's motion to sell did not indicate that the receiver was selling the property free and clear of liens. The trial court ordered a free-and-clear sale that closed without payment to AFF.

AFF appealed on the grounds that the receiver had no authority to sell free of AFF's lien. The appeals court held that in the absence of a receiver's service of a summons and complaint indicating the receiver's intent to sell the parcels free and clear of liens, the trial court lacked authority to authorize the receiver to sell free and clear of AFF's lien without its consent. The appeals court noted the due process protections afforded to litigants in a foreclosure case in contrast to what occurred in Eastlake:

> [T]he procedures mandated by foreclosure are more than statutory "hoops" through which one must jump; they embody real concepts of due process. Notice, opportunity to be heard, independent appraisal, and public sale are designed to protect the interests of all parties; due process is a notion embedded in all court action. A receiver's sale is subject to due process requirements and review, and failure to provide same requires reversal and remand.[35]

Ignoring *Quill*, the two-judge majority followed *Au Rustproofing*, stressing the rights of creditors and lienholders to due process and notice. Having found those procedural safeguards lacking in the case, the appeals court reversed the trial court's approval of the receiver's sale.

[34] Ohio Dept. of Transp. v. Eastlake Land Devel. Co., 894 N.E.2d 1255, 2008-Ohio-3013 (8th Dist.).
[35] Id. at *32 (internal citations omitted).

Proposal for Determination of Free and Clear Sales in Ohio

In an attempt to reconcile the competing holdings of *Quill*, *Au* and *Eastlake*, together with a common law history of allowing sales free and clear of liens, some principles emerge:

1. Due process safeguards should apply to all aspects of a receiver's sale. All lienholders should be served with a complaint and/or motion setting forth the terms of the proposed sale and why the receiver believes the sale is commercially reasonable.
2. A receiver's sale must be a commercially reasonable sale. There should be a good reason to sell the receivership property, such as: (1) the lienholder has consented to the sale; (2) the receiver has obtained a price for receivership property in excess of approved foreclosure or liquidation value; or (3) there is a threat that the property may diminish in value. If there is an objection to the sale, the receiver should be required to offer evidence of the commercial reasonableness of the sale.
3. All liens should attach to the fund created by the sale in the same amount and priority as they attached prior to the sale.

No sale should proceed without adequate notice to lienholders and an opportunity to be heard. In most cases, the preferred means of notice—clearly the safest route—is for the receiver to file a complaint to sell, issue a summons to all lienholders and file a motion to sell, and serve all lienholders of record with a copy of the motion to sell. If any lienholder objects to the sale, the court should set the receiver's motion to sell for an evidentiary hearing.

In large receivership cases with many parties who have been issued a summons and complaint at the beginning of the receivership, it may be acceptable to serve the receiver's motion to sell with a notice of hearing without issuance of a second summons and complaint. If the receivership property is the subject of a foreclosure, it is safer still to have liens judicially determined in a decree of foreclosure prior to any sale by the receiver. In no event, however, should a receiver request, nor should a court

approve, a receiver's sale without notice and the opportunity for interested parties to be heard.

In reviewing cases such as *Eastlake* where orders approving receiver sales were reversed, we have noticed a problem with an absence of procedures protecting the rights of lienholders to due process and/or with the receiver's failure to show the court that a proposed sale of receivership property is commercially reasonable. We suggest that if there is an objection to the sale, the burden should be on the receiver to offer evidence that the sale is commercially reasonable.

Finally, the order approving a receiver's sale should provide that liens attach to the proceeds of sale in the order they appear in the title report or any order of court that determines the existence and amount of liens.

Model Statute Suggestion

We propose below a model statute setting forth the means by which a receiver may sell receivership property free and clear of liens. We believe it works well for the sale of personal property or real property[36] that has become receivership property pursuant to court order.

Sale of Receivership Property by Receiver

1. The receiver may use, sell or lease receivership property other than in the ordinary course of business. The receiver shall give reasonable notice of his intention to sell or lease receivership property, the terms of such proposed sale or lease to all lienholders and other persons requesting notice of sale.
2. The court may order that a sale of receivership property under section 1 may be effected free and clear of liens and all rights of redemption irrespective of whether the proceeds of sale will be sufficient to satisfy all claims secured by receivership property.
3. If a lien creditor files a timely objection to the proposed sale of receivership property by the receiver, the court shall set the receiver's motion to sell receivership property for hearing and advise all parties of the time and date of such hearing.
4. The receiver shall have the burden to prove the commercial reasonableness of the proposed sale of receivership property. Indicia of commercial reasonableness include, but are not limited to the following:
   a. Consent of some or all lienholders to the sale;
   b. The receiver has obtained a price for receivership property in excess of appraised, foreclosure and/or liquidation value;
   c. There is a threat that the receivership property will diminish in value; and
   d. Other factors peculiar to the receivership property.
5. Upon any sale free and clear of liens authorized by this section, all mortgages, security interests and/or other liens encumbering receivership property shall attach to the proceeds of the sale, net of reasonable expenses incurred in the disposition of receivership property, in the same order, priority and validity as the liens had with respect to the receivership property immediately before the conveyance.
6. The court may authorize the receiver at the time of sale to satisfy, in whole or part, any allowed claim secured by receivership property out of the proceeds of its sale if the interest of any other creditor having a lien against the proceeds of the sale would not thereby be impaired.

Conclusion

The remedy of receivership is attractive for its cost-effectiveness, flexibility and, most of all, for the broad powers a trial judge may give the receiver to act in the best interest of the receivership estate. While sales by equity receivers free and clear of liens will continue to be approved by trial courts based on common law authority, adoption of a statute allowing for sales free and clear of liens may improve the receivership process by ensuring a predictable and fair sales process. ■

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[36] This proposed statute does not affect in any way a creditor's remedy of foreclosure or a secured party sale under Article 9.